# Russia

## OUTLOOK 2023

**www.intellinews.com**

To subscribe to this report contact our sales team Email: sales@intellinews.com

A complete list of all our reports can be found at http://pro.intellinews.com/reports

# Table of contents

# 1.0 Executive summary

**The Russian economy is approaching the end of 2022 in a far better state than many had anticipated in the spring following the invasion of Ukraine** and ensuing Western sanctions. The fall in GDP has only amounted to about 3% or even less, and the US dollar is still trading at less than 65 rubles. Even the Western ban on high-tech imports, although challenging, has proved manageable. But none of this means that Russia's economy is out of the woods: many risks still remain. We asked economists from Russia's leading investment banks to highlight the new warning signs that have emerged in recent months.

**Oil and gas revenues started to fall sharply**. In November, oil and gas revenues contributed RUB866 billion ($13 billion) to the state budget – down 2.1% year on year. This is not a critical fall in revenues. However, in reality, almost half of that sum ($6.4 billion) came from a one-off payment of Gazprom's mineral extraction taxes. Without that money, oil and gas income was down 48.9% compared with 2021.

There are two possible reasons for this. First is the near-total cessation of pipeline gas exports to Gazprom's lucrative European market following the closure and subsequent explosions on the Nord Stream gas pipeline. Second is the fall in prices for Russian oil, which led to November's oil revenues being down 25.4% y/y.

**Russia's Finance Ministry is printing money to cover this deficit.** Part of the hole can be filled using the National Welfare Fund, but this alone will not be enough. Relying solely on the NWF would mean the liquid part of that fund would run out by 2025 according to the projected budget deficit, Central Bank analysts reported.

This fall, the Finance Ministry turned to large-scale borrowing in the federal loan bond market to cover the rest of the deficit. These internal loans raised RUB1.44 trillion ($22 billion) for the ministry. Of this sum, 77% derives from bonds floating rates, which will ultimately be tied to Central Bank rates. The main buyers of these bonds were leading banks, which previously borrowed RUB1.39 trillion ($21 billion) through REPO transactions. Therefore we are effectively looking at hidden money emission.

This has obvious consequences: it will likely increase inflationary pressure, forcing the Central Bank to raise interest rates and sacrifice economic growth. However, not every economist regards this scheme as inflationary. Economist Viktor Tunev believes that, from the point of view of modern monetary theory, this borrowing algorithm will have no significant economic consequences. He calls these loans "Russian QE": the Central Bank creates liquidity in the form of federal loan bonds, simultaneously improving standards in assets and enhancing money supplies to the banks' liability without involving capital.

**Unemployment levels in Russia remain close to historic lows** even as foreign companies have left the market and factories have closed. The latest official figures show that 3.9% of the workforce was unemployed in October (the all-time low of 3.8% unemployment was set in August).

There are several possible explanations for this paradox. First, Russia's labour market always responds to a crisis by cutting salaries first, not jobs. Second, the low level of benefit payments in Russia means that people who do lose their jobs are likely to grab any job they can as soon as possible.

On top of this, Russia launched its military mobilisation amid this "compressed" labour market, said Rostislav Kapelyushnikov, deputy director of the Center for Labor Market Studies at Moscow's Higher School of Economics. The loss of approximately 1-1.5 million people from the labour market due to war-related mobilisation and emigration will exacerbate the situation with a growing pool of unfilled vacancies.

This serves as a wake-up call that Russia's labour resources are limited, says Alexander Isakov, an economist specialising in Russia and Central & Eastern Europe at Bloomberg Economics. Because there are no spare resources in the economy, mobilisation requires those working in "productive" industries (such as processing, construction and transport) to be diverted into the state sector. All of this impedes potential economic growth: increased defence and public sector spending have structural side-effects that will limit potential annual growth to about 0.5% over the coming five years, Isakov says.

**Russia's real estate market is currently experiencing a bubble due to cheap mortgages.** The current programme of discounted mortgages at a rate of 7% was due to end in Russia at the end of this year. Both the Central Bank and the Accounts Chamber have repeatedly called for the scheme to be cancelled. However, President Vladimir Putin recently announced that the programme would continue, albeit at a slightly higher rate of 8%. These discounted mortgages are causing Russia's real estate market to overheat. The primary and secondary housing markets are unbalanced (the price difference between a new apartment and a "maintained" apartment is now 40%).

Subsidies have made housing more affordable for more citizens, who have decided to take out mortgages now rather than wait. Demand has risen sharply – faster than supply can adapt – and prices are soaring. In Moscow, it is now impossible to buy a comfort-class apartment in a new building without taking out a mortgage. However, this bubble is unlikely to burst, according to independent financial analyst Sergei Skatov: developers have already sold more than 51% of the housing due to come onto the market by the end of 2023. They need to sell a further 10-20%, which is entirely achievable even if demand falls to summer levels. Defaults on mortgage portfolios could also burst the bubble, but with a failure rate of just 0.4% (and 0.15% in the primary market), this is also unlikely, Skatov said.

**Economic outlook**

**The EU saw a €1 trillion bill for gas prices, since the beginning of the Russian war on Ukraine.** The subsidies of EU states accounted for ~ €700bn. 2023 will be as difficult as prices will be above €1,000 per 1,000 cubic metres, while budget costs in 2022 were 2-7.5% of GDP.

The cost to Russia is probably even higher. According to a *bne IntelliNews* back of the envelope calculation, the war has cost Russia around $200 billion, just counting the military spending plus the value of a 3% contraction, but that is equivalent to some 7%-8% of GDP. Those costs are bound to rise in 2023 as the effect of sanctions start to bite.

**Russia's invasion of Ukraine in February has changed everything for everyone.** The tragedy is that in October 2021, just before this crisis started, Russia's economy was booming. A dozen companies had done billion-dollar IPOs. Incomes were rising. The leading companies were expanding abroad. The budget was healthy and in surplus. It appeared that Russia had finally emerged as a first world country.

Then Russian President Vladimir Putin wrecked it all by insisting on his no-Nato for Ukraine deal, a demand he backed with the threat of force and when no deal was forthcoming he followed through on his threat. The upshot is we are now living in a **fractured world** that is fuelling a polycrisis from which it is unlikely that we will emerge for several years.

**Remarkably, Russia's economy has had a very good year in 2022** considering the "massive package" of the sanctions inflicted on it in March about a week after it crossed the border into Ukraine.

At the start of the war the consensus was that Russia's economy would contract by at least 15% – worse than the 8% contraction Russia suffered in both the 1998 and 2008 crises. As the year drew to an end the consensus was the contraction would be a little less than 3%.

**Most of the macroeconomic results have done far better than expected.** Inflation is high but as the Central Bank of Russia (CBR) was one of the first to start hiking well before the war started, it is falling now and is around 12% – far better than the circa 20% that is across Central Europe.

Everything is of course down, but only mildly. Life on the streets of Moscow is pretty much normal and although many of the international brands have left Russia, the parallel imports (mainly via Turkey, but also via Serbia, Central Asia and the Caucasus) are kicking in, so most of the international brand names are available again.

**The ban on seaborne shipments of Russian crude oil to EU countries went into effect on December 5.** The ban does not apply to crude oil transmitted by pipeline. Germany and Poland, the largest European buyers of Russian pipeline crude, have announced that they will also suspend their pipeline imports, which have already fallen close to zero.

A few EU buyers (Hungary, Czech Republic and Slovakia) will at least temporarily continue to import Russian pipeline oil for about a year. Most of EU crude oil imports from Russia, however, are now ending.

Russia must find new buyers for about a quarter of its crude oil exports. A separate import ban on Russian petroleum products enters into force in February 2023, which are much more widely distributed in Europe.

The G7 countries also imposed a price cap on seaborne Russian crude. Under the agreement, maritime services related to the transport of Russian crude oil can only be offered for oil priced below the price cap.

The price cap is currently set at $60 a barrel, but could be revised later. Russian Urals-blend crude was already trading below the cap price before the cap entered into force. Russian officials have discussed countermeasures to address the price cap, but nothing has yet been decided. A similar price cap for petroleum products should enter into force in February 2023. Another price cap for gas is being discussed but no agreement amongst the fractious EU has been reached on that either.

The European Commission proposed its ninth package of Russia sanctions in December, but Hungary says energy will not be part of it. Among other things, the latest round names a number of Russian individuals, companies and banks not previously sanctioned, as well as further export restrictions. For example, the export of drone engines to Russia or potential third-country suppliers is banned. In addition, new export controls and restrictions particularly on dual-use products are planned, including chemicals and IT components.

**The shock in December was the manufacturing PMI expanded to 53.2 – its biggest increase in more than five years**. Economists believe the rise was due to state spending as the Kremlin has put the Russian economy on a war footing and is pouring money into manufacturing, but the services sector, while also improving, is still in decline.

But Russians in general seem to accept the increased hardship, as they have mostly bought into Russian President Vladimir Putin's line that Russia is fighting a proxy war and is under attack by Nato – something that is not entirely untrue.

On top of the strength of Putin's Fiscal Fortress that has proved to be far more effective at shielding Russia from sanctions than hoped, the effect of the partial sanctions and self-sanctioning has been to drive up commodity prices to the point where they far outweigh the reduction of volumes of commodities exported.

**And instead of collapsing the economy, Russia is rolling in money.** Russia should end 2022 with a current account surplus of some $250bn – more than twice the $120bn it ended 2021 with, and that was already an all-time high record.

**The effect of the sanctions in the short term has been limited – and actually in many ways counterproductive – but the long-term effects will be devastating.**

Cut off from technology, sophisticated equipment and many of the inputs Russia relies on – Russia imports all its seed potatoes, hatching eggs, print ink and much of its quality paper, for example – its long-term growth potential has been reduced from the already low 2% to about 1% now. With global growth regularly over 4% or more, Russia's economy is destined to stagnate and slowly fall behind that of the rest of the world in the coming decade.

**Russia's economic health will almost certainly worsen in 2023.** The federal budget is expected to end 2022 with about a 2% of GDP deficit, but was still in surplus in November, but only thanks to a special RUB450 billion ($7.1 billion) tax payment by Gazprom.

The oil embargo and related oil price cap scheme that was implemented on December 5 will also prove to be largely ineffective but will reduce Russian oil exports and/or production by about 1mn barrels per day (bpd), say analysts, bring the current account surplus down to around $100 billion in 2023 and increase the 2023 budget deficit to 3%, up from the 2% that has been pencilled in by the Ministry of Finance (MinFin). While all these things are painful, none of them are devastating and both the Kremlin and the people are willing to take this pain for the moment.

Russia's economy is likely to limp on as business tries to remake itself with relations in the Global South. While Russia will be cut off from the latest technology it is now trying to marry itself to the faster growing part of the global economy that will somewhat mitigate the pain of leaving the advanced economies. Moreover, Russia has a lot to offer the emerging world as it remains a cornucopia of raw materials and fuel, while its military and energy technology – especially nuclear power – remains advanced and attractive.

**The most likely outcome for Russia's economic development will be these relations will sustain it** and allow Putin to placate the population to avoid popular unrest. At the same time, sanction leakage and the ability of regular Russians to continue to travel will mean the shops will remain full of modern creature comforts and the significant leakage in the sanctions regime will also keep business ticking over.

All of this will very likely be enough to keep Putin in office until his term expires in 2024 – and probably longer.

## Political outlook

There seems little hope now that Russia can reverse the damage and undo the sanctions it has brought down on itself. All of Russia's diplomatic efforts in the last months of 2022 were focused on reducing the sanctions, but it has made little progress. During the renewal of the Istanbul grain deal on November 17 the Kremlin pushed for a reduction of sanctions and shipping of its own agricultural products, but won few concessions. The Kremlin has little real leverage and while Kyiv was open to peace talks in March and April, despite the resurgence of talking about possible talks in November and December, Ukrainian President Volodymyr Zelenskiy and the vast majority of the Ukrainian people are committed to fighting the war to the bitter end, unless talks are forced on them by a weary Europe.

That might happen, as by November it was clear that a certain Ukraine fatigue was appearing in the West. While the US has been making a profit out of the war thanks to its capture of Russia's share of the European gas market with its record-high LNG exports, the cost to Europe has been enormous. According to *bne IntelliNews* estimates Europe had committed some €550bn to support and relief for companies and consumers by December and the cost of the war to European economies was on course to top €1 trillion by the end of winter.

Moreover, as any expansion of the war will be fought in Europe, that at a minimum will unleash a flood of millions of Ukrainian refugees, Nato has made it very clear its first priority is to prevent an escalation of the war that could pull Nato members in. Ejecting Russia from Ukrainian territory is a distant second but ensuring that Russia does not conquer Ukraine is still a high priority and Nato and Brussels will continue to equip Ukraine to ensure that end.

As for the chances of either coloured revolution or a palace coup in Russia, both remain very unlikely. Putin has effectively crushed all popular opposition to his rule and at the same time run a very effective propaganda campaign that has convinced the vast majority of Russians to rally to the flag.

A palace coup remains unlikely while Putin commands the loyalty of the population – his approval rating in December had dropped only 2pp to 78% despite the humiliating success of Ukraine's Kharkiv offences and the decision to retreat from Kherson – which makes him untouchable by the Russian elite. Moreover, as any change in guard at the top would likely be accompanied by a purge and redistribution of control of Russia's richest assets, the majority of Russia's ruling elite have little incentive to rock the boat.

# 2.0 Politics

Politics in Russian in 2021 was marked by a nasty change in tempo from what *bne IntelliNews* columnist Mark Galeotti dubbed "repression-lite" to the real thing. That change culminated in the invasion of Ukraine in February 2022.

Opposition figures, starting with anti-corruption activist Alexei Navalny, were jailed or driven into exile. Opposition papers were branded "foreign agents" and taken over, closed down or simply put out of business.

The Kremlin took the gloves off and noticeably tightened its control over the system as it prepared for the crucial September 2021 general election, which of course it won handsomely, putting the ruling United Russia party back into power using blatant vote fixing, largely through the introduction of an opaque electronic voting system over which it had complete control.

The September elections probably mark the last of the semi-free votes as the electronic voting system was only used in 17 of Russia's 85 regions, but by the next elections it will be rolled out across the country.

The immediate goal was to ensure the re-election of United Russia, which was doing badly in the polls. The irony is that United Russia would have still won an open and free election, according to the statistical studies that show up the rigging very clearly.

But elections in Russia are not so much about "winners" as "thresholds." In a free race the Communist Party of the Russian Federation (KPRF) would have won triple as many seats and formed a real opposition block in the Duma and United Russia would have lost control over the crucial Duma committees that actually make the laws. It would have opened up parliamentary debate and all the horse trading of party politics that comes with it. The Kremlin is still not prepared to share power with anyone, even the compliant KPRF, and the KPRF is not prepared to play the role of a true opposition party, although it could.

Russia's opposition is divided into the "systemic" and "non-systemic" opposition. Those in the former category, including the KPRF and the iconoclastic LDPR part of the deceased Vladimir Zhirinovsky, give a semblance of democracy, but are compliant when the Kremlin needs them to be. The leaders of the non-systemic opposition have either been driven into exile, jailed or killed.

The crackdown on the opposition was probably triggered by Navalny's return to Russia despite the fact his arrest if he did return was well telegraphed in advance. Navalny calculated that his arrest would trigger international outrage, which it did. Where he possibly miscalculated is in the strength of his support in the country and just how far the West would go to punish Russia for its abuse of his rights.

Navalny called for mass protests and hundreds of thousands did come out onto the streets in two rallies in January, but the protests failed to reach critical mass and polls show that the majority of those protesting were protesting against the Kremlin's extra-judicial treatment of him rather than supporting Navalny per se. The protests petered out and a third in the spring failed to draw significant numbers.

The West also baulked at imposing crushing sanctions on Russia to punish the Kremlin for his arrest, although the complaints were loud and public. Brussels has become shy of forming policy around individual cases after it tied aid to Ukraine to the release of opposition firebrand Yulia Tymoshenko, after then president Viktor Yanukovych jailed her on trumped-up charges. When she was finally released after Yanukovych fled the country following the EuroMaidan revolution in 2014 Tymoshenko was well received by the crowd, but had clearly lost her authority and much of her popularity.

**Without an effective opposition in Russia the chances of Putin being ousted by some sort of colour revolution are very low.**

Nevertheless, Putin has taken considerable risks by starting a war in Ukraine. Shortly after the invasion, hundreds of thousands of young Russians, many of them in the IT sector, fled the country to visa-free neighbours like Turkey and Georgia.

Putin took an even bigger gamble in September with a partial mobilisation that started on September 21. The decision to conscript 300,000 men in effect broke Putin's famous social contract with the people: don't interfere with politics and we won't interfere with your daily lives.

However, as the number of those conscripted is less than 1% of the population and was concentrated in some of the poorest regions of Russia's interior such as Dagestan, the lives of the bulk of Russians, who mostly live in the European parts of the country, did remain unaffected; Putin hedged his bet.

Falling popularity and looming presidential elections in 2024 were other reasons for the crackdown that started in 2021. Putin's popularity has been falling slowly as society slowly politically matures. Putin's personal approval ratings remain high in the mid 60s for most of the years following a spike to 80% after the annexation of the Crimea, but his trust rating is sinking slowly.

There is now a whole generation that was born after the fall of the Soviet Union, which had its 30 birthday in December last year, and that were children in the hell of the 90s. This more worldly generation are relatively comfortable and starting to demand more from the government in terms of services, opportunity and wanting more say in government.

**Analysts argue that the start of the fall in Putin's popularity began in 2018 when pension retirement ages were raised,** which was also a blow to his classic Putin-era social contract. A high level of support for Putin in the 2018 presidential elections was mistakenly interpreted by the authorities as real political credit, rather than indifference and mostly symbolic trust.

While purely political opposition remains stunted, protests on quality of life issues can become large and vocal, which the Kremlin is struggling to contain. It is clear that this dissent will eventually transform into large-scale popular unrest, but for the moment Russians feel they have more to lose than to gain from a colour revolution, with Ukraine providing the object lesson to curb their revolutionary zeal. That gives Putin a year to deal with the problem before the 2024 elections, but in the meantime, he is already shoring up his control to buy more time.

**The other key recent change was the change to the constitution in June-July 2020** that allows Putin to stand for two more terms. His current term expires in 2024, but he could stand again and stay in office until 2036 if he choses. (He has not confirmed that he will run in 2024.)

The change was designed to prevent the inevitable jockeying amongst the Kremlin fractions to find an acceptable replacement for Putin. He himself said in November 2021 that the uncertainty over his candidacy brings stability to Russian politics as that jockeying won't start until it is clear that he is leaving. The danger is that the jockeying would destabilise domestic politics and reduce his power.

**The showdown with the West has been a long time in coming** but the Kremlin has been signalling for over two years it was fed up with being bullied by the West. In February 2020 Russian Foreign Minister Sergei Lavrov gave a "new rules of the game" speech where he said that the Kremlin would no longer tolerate the dual sanctions with one hand and business deals with the other. He humiliated EU foreign policy chief Josep Borrell, who was on a trip to Moscow at the time, and followed up by threatening to break off diplomatic relations a few weeks later. Diplomatic relations with Nato were broken off in the autumn of that year.

The key issue was Putin's insistence that the West commit to never allowing Ukraine to join Nato. Putin had been warning about Nato expansion since his famous speech at the Munich Security Conference in 2007 where he threatened that Russia would push back if his concerns were not addressed.

The origins of Putin's pique at the Nato expansion arguably go back to back to the verbal promises made to Mikhail Gorbachev by most of the Western leaders in 1990, and the US Secretary of State at the time, James Baker, that in the meantime are a matter of historical record. Putin referred to those promises in his Munich speech and has brought them up several times again in the last two years. That is why he was so specific about asking for "legally binding" promises this time round. And his paranoia about Nato's expansion was fed by former president George W Bush's unilateral withdrawal from the ABM treaty  in 2002 and the Nato missiles that were put into place in Romania and Poland subsequently, to nominally protect against "rogue states" – namely North Korea.

The first manifestation of this change came in 2008, when the Russian Foreign Ministry drew up a draft plan for a new pan-European security deal that included a fair specific framework proposal released by the Russian Foreign Ministry in 2009. That was rejected by Nato too. By 2020 he felt Russia was strong enough to act.

2021 was marked by Russia moving troops up to Ukraine's borders twice as the Kremlin attempted to put pressure on the West, and the US in particular, into opening real talks to address Russia's security concerns. Those went nowhere.

In the two-hour December 7 virtual summit between Putin and US President Joe Biden, the Russian leader laid out a set of demands for Nato to commit to "legally binding" guarantees of no further expansion of Nato to the east. Those demands were followed up by an eight-point list of demands issued by the Ministry of Foreign Affairs on December 15, 2021 that was topped by the no-Nato demand for Ukraine.

Two months of diplomacy followed after the New Year's break, first with the US and then led by French President Emmanuel Macron, came to nothing. At the end of February Russia marched into Ukraine.

**Putin's popularity**

Since the war started Putin has enjoyed another spike in nationalistic pride and seen his personal popularity rise again from the 60s back into the low 80s.

**The Kremlin propaganda has been very effective** and has successfully persuaded the majority of Russians that their country is under attack by Nato and that Kyiv is run by a corrupt Nazi regime that is in the pay of the US.

**Recent polls at the end of 2022 have shown a slight cooling of sentiment,** but even Ukraine's highly successful Kharkiv offensive and the Russian retreat from Kherson have not managed to dent his ratings much. Most Russians still consider Russia to be going in the "right direction" and assume that Russia will win the war.

In September a certain Ukraine fatigue became visible and there were suggestions on all sides, except the Ukrainian one, that a return to the peace talks that were held in March and April might be a good idea.

**For his part, Ukrainian President Volodymyr Zelenskiy, and the majority of Ukrainians, have passed the point of no return** and refuse to contemplate talks until Russia has been expelled from the country and Ukraine returned to its 2021 borders, or even its 2013 borders.

**In 2023 it remains to be seen how this plays out.** Some analysts argue that as both sides increasingly come to believe the war is unwinnable, they are becoming more open to a diplomatic solution. The Kremlin has been signalling that it is happy to start talks, but at the same time is suggesting strongly that any talks must end with it still holding the Donbas, the land bridge from Rostov to Crimea and Crimea itself. That is a non-starter for Zelenskiy.

However, as Nato has only been supplying Ukraine largely with defensive weapons and holding back on the offensive tanks, planes and long-range missiles, it seems unlikely that Ukraine's army can make much more territorial progress. For its part Russia has retreated and dug in as winter closes in and its forces will be very hard to dislodge.

**Europe in particular is coming under increasing pressure to end the war** as the polycrisis, and the cost-of-living and energy crises in particular, are putting increasing pressure on the EU government's to find a resolution. There have been only a few mass "end the war" protests already, but the danger is that these will grow. In particular, the worst of the energy crisis in the winter of 2022/23 seems to have been avoided, but it is also becoming increasingly clear that there will be a new and even more severe energy crisis in the winter of 2023/24 that Europe is very keen to avoid.

A long but unfruitful winter campaign may soften everyone up for an attempt at renewed talks, but the situation remains very unpredictable.

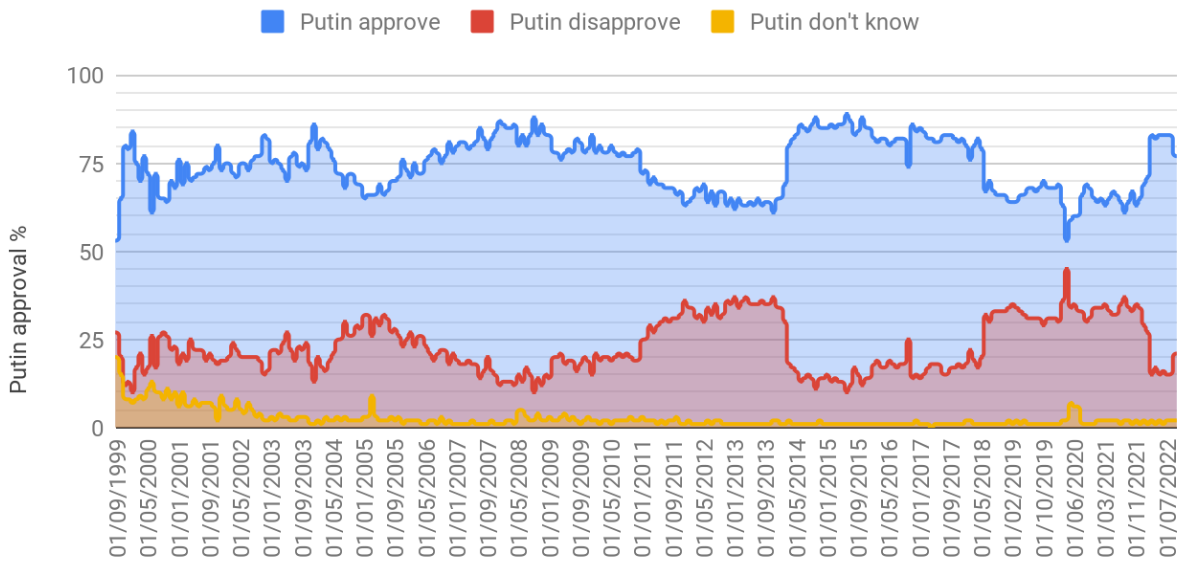
One of the biggest changes in Russia-watching the conflict has brought is that Putin has changed from a slow and careful player, who spends years in his preparation, to someone who has gone at every stage of the conflict to extremes that no one anticipated, starting with the act of a full-scale invasion right at the start of the war. He has become impossible to second-guess and prudence means all the options – including the use of nuclear weapons – remain on the table.

**At home, Putin's time is limited too.** While he retains support for the war, the domestic polls show that support will wane over time, as Russia is suffering from the same cost-of-living crisis. While 86% of Russians were happy with the annexation of Crimea – and remain happy – a Levada Center poll in the autumn shows that only 25% approve of the military action in Donbas. Russians are uncomfortable with Russian troops in a territory they clearly consider to be Ukrainian.

At the end of 2018, 56% of respondents to a Levada Center survey said there was a significant military threat from other countries. This year, the fear of a world war has increased dramatically, reaching a solid second place in a Levada Center list of the top issues causing Russians to worry. The other fears that have risen in parallel with that of war are those of an increasingly harsh political regime, mass repression and arbitrary rule: the authoritarianism of the Russian political regime has not gone unnoticed.

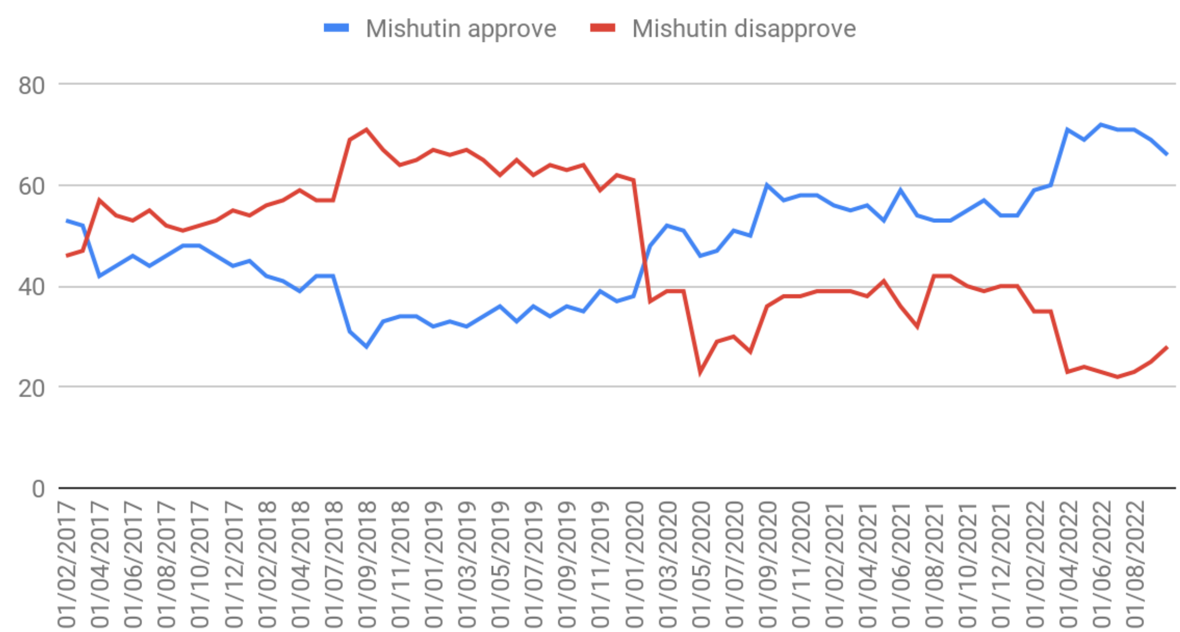
War is the business of young people and conscripts. But 66% of Russians aged between 18 and 24 – the post-Soviet and post-Yeltsin generation – have a positive or very positive attitude toward Ukraine, according to Levada.

**Russia Putin's approval rating %**

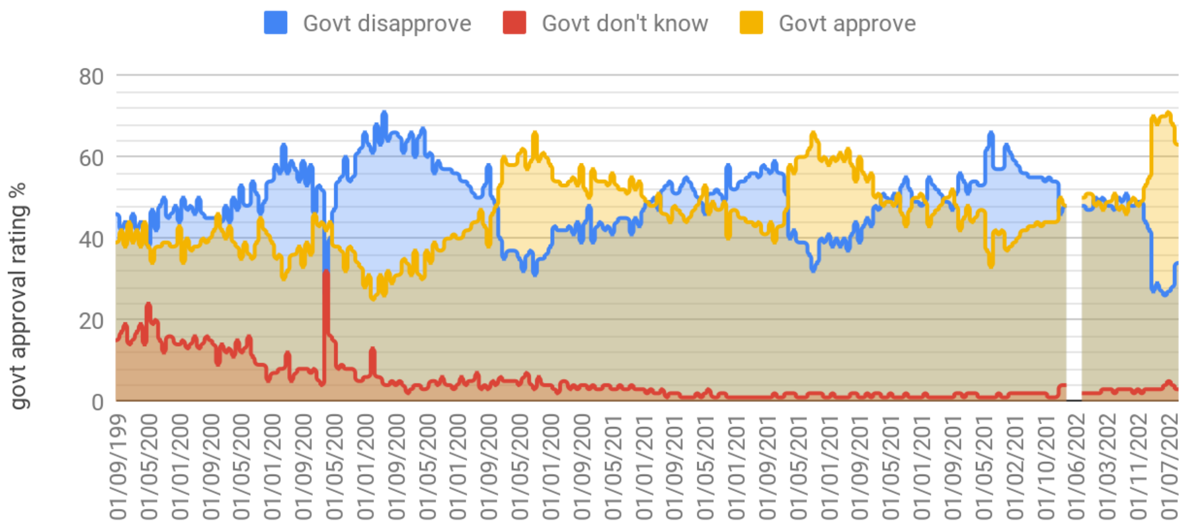



source: Levada Centre

## Mishustin approval %

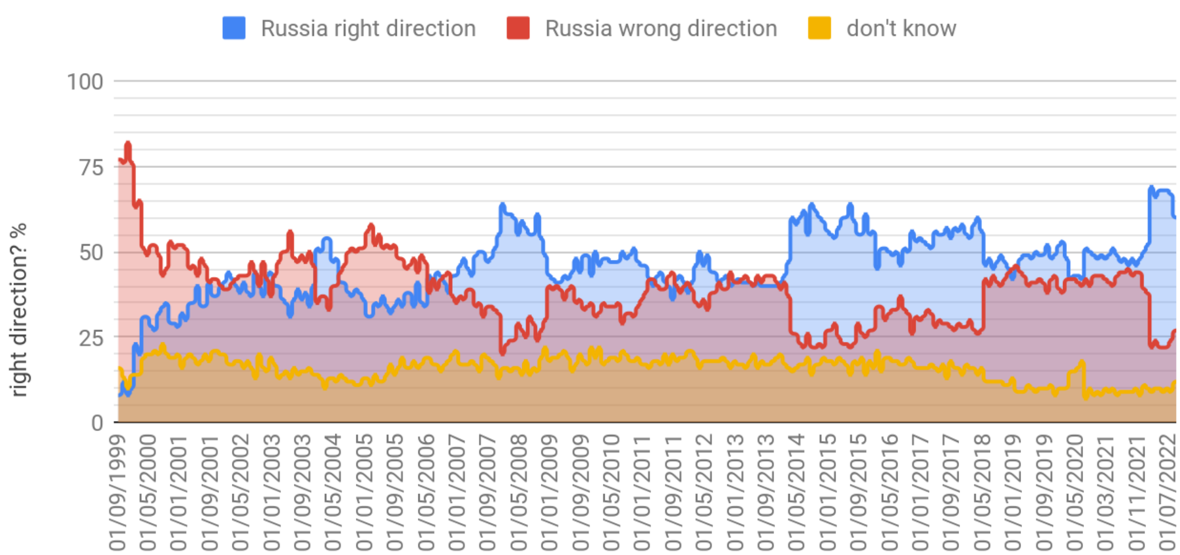


## Russia government approval rate %




source: Levada Centre

## Russia Country going in right direction?




source: Levada Centre

# 3.0 Macro Economy

## Survey results: October 2022*

| | 2021 (actual) | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|
| **CPI** **(%, Dec to Dec of the previous year)** | 8,4 | 12,5 (12,9) | 6,0 (6,0) | 4,2 (4,0) | 4,0 (4,0) |
| **Key rate** **(% per annum, average for the year, including weekends)** | 5,7 | 10,6 (10,5) | 7,1 (6,8) | 6,4 (6,1) | 6,0 (5,7) |
| **GDP** **(%, YoY)** | 4,7 | -3,5 (-4,2) | -2,1 (-1,8) | 1,5 (1,7) | 1,7 (1,6) |
| **Unemployment rate** **(%, Dec, not seasonally adjusted)** | 4,3 | 4,1 (4,9) | 4,6 (4,9) | 4,5 (4,5) | 4,3 (4,3) |
| **Nominal wages** **(%, YoY)** | 11,5 | 10,6 (10,4) | 7,0 (7,0) | 6,4 (6,3) | 6,0 (6,0) |
| **Exports of goods and services** **(billions of US dollars per year)** | 550 | 598 (566) | 487 (480) | 460 (445) | 445 (436) |
| **Imports of goods and services** **(billions of US dollars per year)** | 380 | 331 (313) | 345 (332) | 353 (350) | 370 (353) |
| **USD / RUB rate** **(RUB per USD, average for the year)** | 73,7 | 68,4 (69,4) | 71,4 (73,1) | 74,7 (75,3) | 75,0 (79,7) |

| | | |
|---|---|---|
| **Neutral key rate** **(% per annum)** | 5,5 (6,0) | The level of the key rate at which monetary policy keeps inflation and inflation expectations on target over the long term and also keeps GDP at its potential. |
| **Long-term GDP** **(%, YoY)** | 1,5 (1,5) | Expected average potential GDP growth rates in 2026 - 2030. |

* In parentheses are the results of the September 2022 survey.

Survey Dates: 12 — 18 October, 2022.

Calculation methodology: The survey results are the median of the 26 forecasts of economists from various organizations taking part in the survey.

## • GDP

**The expectations of a large contraction for the Russian economy have been constantly revised down over the year**. In March analysts were predicting a contraction of at least 15%, but by December the latest forecast is for a mild 2.9% contraction, and some sectors like oil production are expected to beat last year's production levels.

The GDP contraction eased from a 6% q/q fall in the second quarter 2022 to 4.1% in the third to a 4% in the fourth quarter – a very small expansion in quarter on quarter terms.

Russia's government assumes that economic contraction in the country will not exceed 1% in 2023, First Deputy Prime Minister Andrey Belousov told reporters on December 16. The Russian Economic Development Ministry's official outlook for next year suggests a GDP contraction of 0.8%. This outlook remains unchanged so far, Belousov said.

The robustness of the economy is being helped by very high energy prices as Russia continues to export very large amounts of oil to the EU and new customers in Asia. Imports have also bounced back as new routes to Russia have been found and the parallel import mechanisms kick in.

"Even so, the economy is struggling for momentum and the outlook looks bleak," Capital Economics said in a note. At the same time, the price of Urals has fallen from $80 to $55 as of December and this is likely to have a bigger impact on Russia's revenues than the oil price cap.

"Russia has already passed peak current account surplus." says Capital Economics, which predicts that energy export revenues will drop from $320bn in 2022 to $200bn in 2023.

The Central Bank of Russia (CBR) forecasts collected by Consensus Economics from 19 research institutes for this year's GDP change is −4.2%, and for next year's −3%. The forecast for 2023 remains unchanged, i.e. the economy is expected to contract by 1-4% next year and grow by 1.5-2.5% a year in 2024 and 2025.

Domestic demand is forecasted to weaken less than previously predited this year. Household consumption is expected to contract by 3–3.5%, while investment could even rise in the range of 0-1%. Exports should contract by 15-16%, while imports decline by 22.5-23.5%.

That is on a par with other leading forecasters. The Bank of Finland Institute for Emerging Economies (BOFIT) forecasted published in October expects GDP to contract by 4% both this year and next year, but its projections will also be revised down.

In terms of the damage to the Russian economy from the war and sanctions, in September the EBRD forecast that the country's GDP would fall 5% this year and 3% in 2023, while wiiw has predicted a fall of just 3.5% this year and 3% in 2023.

“This is an unpleasant recession but it's still manageable,” EBRD chief economist Beata Javorcik told *bne IntelliNews* in an interview, pointing out that it was less than some Western European economies contracted during the worst of the coronavirus (COVID-19) pandemic. “The initial expectations that sanctions would result in a financial and economic crisis were not realistic,” she said.

**Many factors have gone into holding up the economy.** The extremely high price of energy and commodities have sent a flood of money to Russia as oil exports rapidly recovered over the summer as deliveries reorientated to Asia.

Import substitution via markets like Turkey also meant many of the inputs that disappeared in the first months of the war reappeared. At the same time, Russian firms were successful in finding new suppliers for many of their inputs. The strength of Russian companies also helped her with offsetting the higher transport costs. Domestic output has also been boosted as local producers stepped into some of the niches.

However, Javorcik argued that sanctions were still severely hitting the economy. “Where you see sanctions working is in the fact that there is a bigger decline in manufacturing output in industries that rely on imported inputs than in manufacturing as a whole,” she said.

**Russia's GDP growth will be awful in 2023.** That's because there's a big negative base effect from the drop in 2Q2022 GDP, so – even if GDP stabilises towards end-2023 – annual average growth will be -5%, says Robin Brooks of IIF.

**The economy was already slowing in the last quarter of 2022.** According to preliminary data from the Ministry of Economy and RosStat, Russia's GDP has shrunk by 4-5% y/y in the last months of 2022. The Ministry of Finance's preliminary estimate indicates that a similar decline continued in October as well. In the most recent forecasts, Russia's GDP is typically expected to contract by 3-5% both this year and next year.

Economic development has continued to be weighed down, especially by weak consumption. The amount of retail sales in October was still 10% lower than a year earlier. Inflation has remained rapid and has eroded the purchasing power of Russian consumers. In October, consumer prices rose by 13% y/y.

The labour market situation has remained tight. The unemployment rate is still historically low at around 4%. Russia's partial mobilisation has partly reduced the workforce, as hundreds of thousands of working-age men have been sent to the front and fled the country.

In October, the economy was mainly supported by the industrial sectors linked to business launch and the military industry, and construction. For example, the clothing industry, metal processing, and the manufacture of electronic and optical equipment grew rapidly from the year before. However, the production of the entire processing industry shrank by 2%.

Construction growth accelerated in October and was 10%. Construction was driven by things other than residential construction, as residential construction shrank by 11% y/y.

The extractive industry contracted in October by 3% y/y. Crude oil production continued the fine contraction seen in recent months. Natural gas production levelled off in October, but throughout this year it has contracted sharply.


**On November 2, the Central Bank of Russia (CBR) published its "Main directions of unified state monetary policy for 2023** and the period of 2024 to 2025."

In this document, the CBR forecasts the development of the Russian economy under "baseline," "accelerated adaptation," and "global crisis" scenarios. It also reiterates its main goal of achieving price stability with a flexible inflation targeting strategy, ultimately keeping inflation close to 4% permanently.

The "**baseline scenario"** assumes that persistently high inflation will lead to tightened monetary policy worldwide. It also takes into account the impact of current sanctions on the Russian economy. Under these conditions, the CBR expects to maintain a key rate of 6.5-8.5% during 2023 in order to reach the

4% inflation target in 2024. The Russian economy is anticipated to shrink in 2022, but transition to growth by the second half of 2023 into 2024, finally stabilising at 1.5-2.5% growth in 2025.

The “**accelerated adaptation**” scenario is even more optimistic, assuming a large-scale global recession will be avoided, new economic ties will lead to better import dynamics and Russian domestic demand will recover faster. Under this scenario, inflation will reach the 4% target by the end of 2023 with looser monetary policy.

The “**global crisis**” scenario, on the other hand, assumes that an increasingly fragmented global economy will lead to a recession on the scale of the 2008 financial crisis. It also assumes that increasing geopolitical tensions will result in new sanctions against the Russian economy. This will contribute to declining Russian GDP in 2023 and 2024, with a 1% increase possible only in 2025.

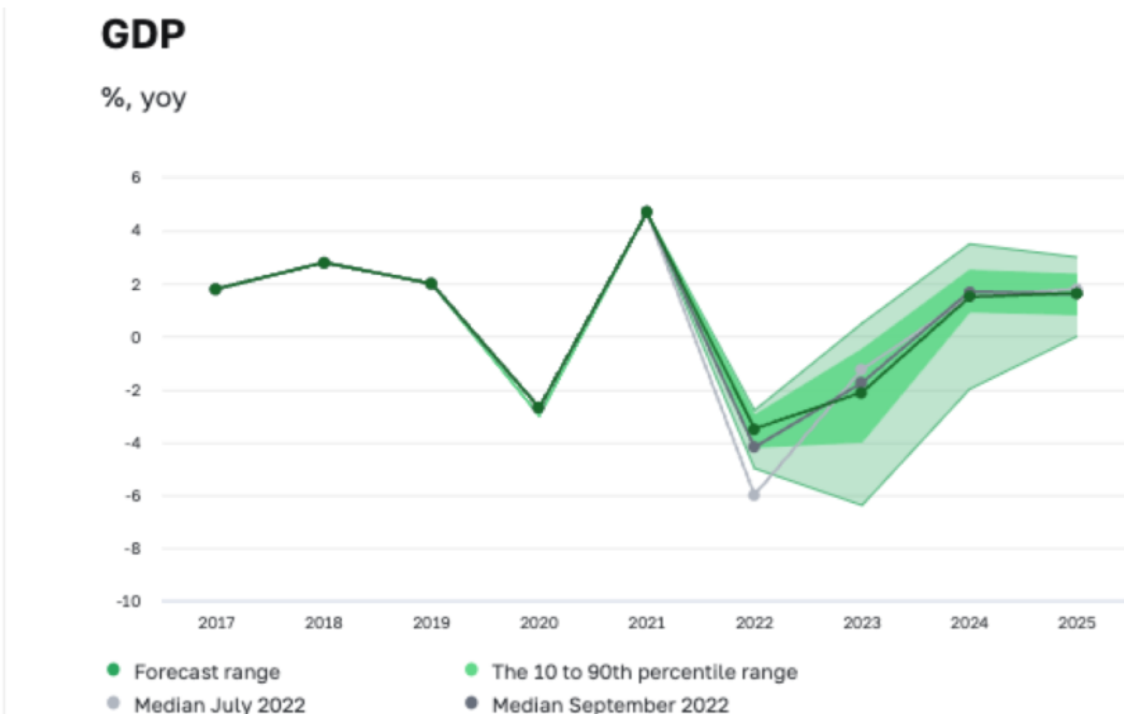
Just a few days earlier, on October 28, the CBR Board of Directors elected to maintain the key rate at 7.5%. This is the first time since the beginning of the war that the rate has been left unchanged. The Bank explained that it expects partial mobilisation to deter consumer demand and inflation in the next few months. The CBR will hold its next key rate review meeting on December 16.

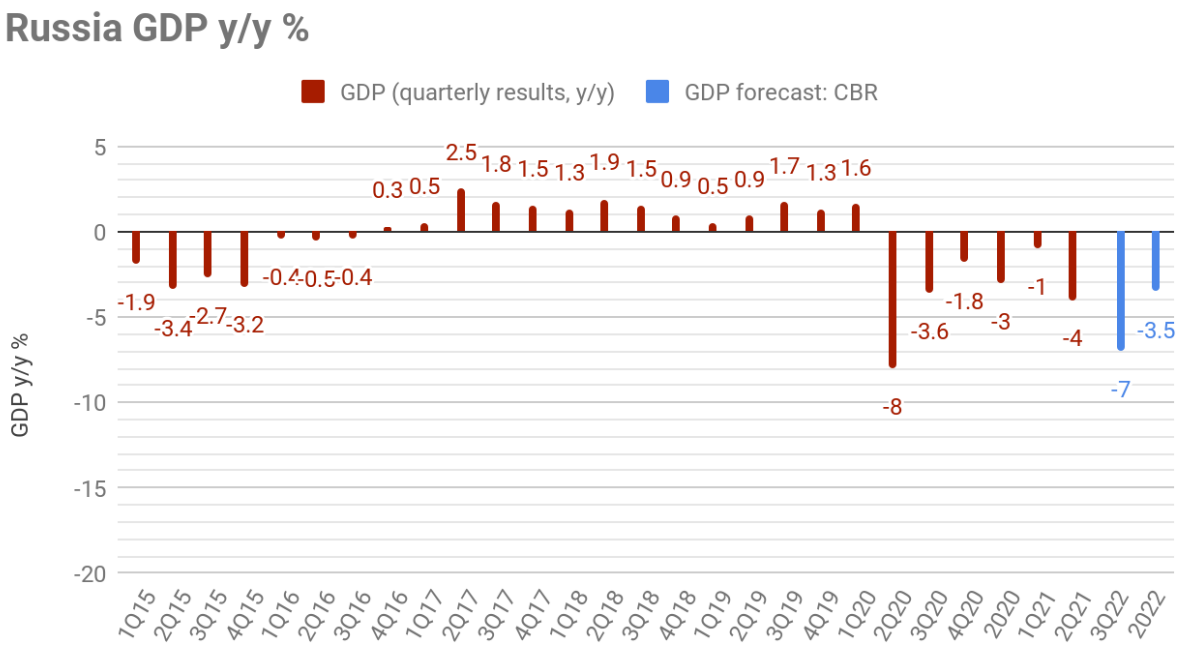
| Russian GDP growth in 2023 forecasts | |
|---|---|
| Alfa Bank | |
| Sova Capital | |
| Economic Development Ministry | |
| CBR | |
| World Bank | |
| IMF | |
| EBRD | |
| Capital Economics | 2.5% |

**Table 5: Key Forecasts** (% y/y unless stated)

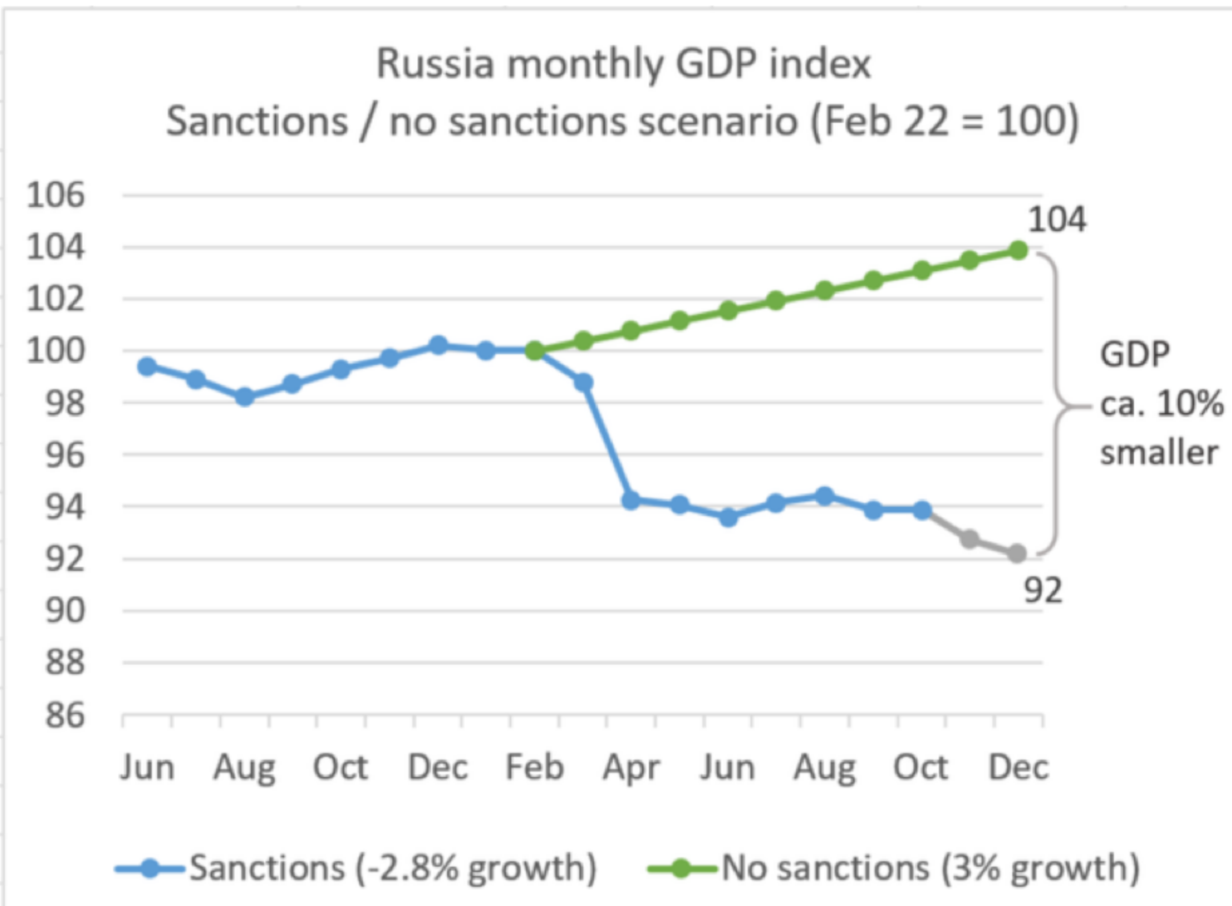
| | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| GDP | -2.7 | 4.7 | **-2.5** | **-2.3** | **1.8** |
| Unemp. Rate (%) | 5.8 | 4.8 | **3.9** | **3.9** | **4.5** |
| CPI Inflation | 3.4 | 6.7 | **13.8** | **5.8** | **5.0** |
| | | | | | |
| Fed'l Gov't Bal[1] | -3.8 | 0.4 | **-1.8** | **-2.0** | **-2.5** |
| Gen'l Gov't Debt[1] | 19.2 | 17.0 | **17.0** | **18.3** | **19.5** |
| Current Account[1] | 2.3 | 6.8 | **11.0** | **3.3** | **2.0** |
| | | | | | |
| Interest Rate (%)[2] | 4.25 | 8.50 | **7.50** | **7.00** | **6.50** |
| RUB/USD[2] | 74.3 | 73.8 | **65.0** | **70.0** | **75.0** |

Sources: Refinitiv, Capital Economics. 1) % of GDP. 2) Year-end






source: Rosstat, Ministry of Economy



## • Energy Crisis

**It looks increasingly likely that Europe will make it through the winter of 2022 with sufficient gas supply, but the International Energy Agency (IEA) warned of a 27bn cubic metre supply-demand gap in 2030 that will be almost impossible to fill.**

**EU storage continued to grow until mid-November, reaching nearly 96% full.** Gas started to be withdrawn from the tanks on November 14 as the cold weather arrived. The storage level peak in 2022 was well above the five-year average of almost 88% for mid-November. Given the bloated storage, day-ahead TTF prices tumbled in November as much as 93% from the peak in August as the gas shortage turned into a gas glut. LNG tankers arriving in European waters stacked up at anchor as the available storage space in the EU's tanks fell to close to zero. Europe was in a better-than-expected position for this winter temporarily alleviating fears of a crisis.

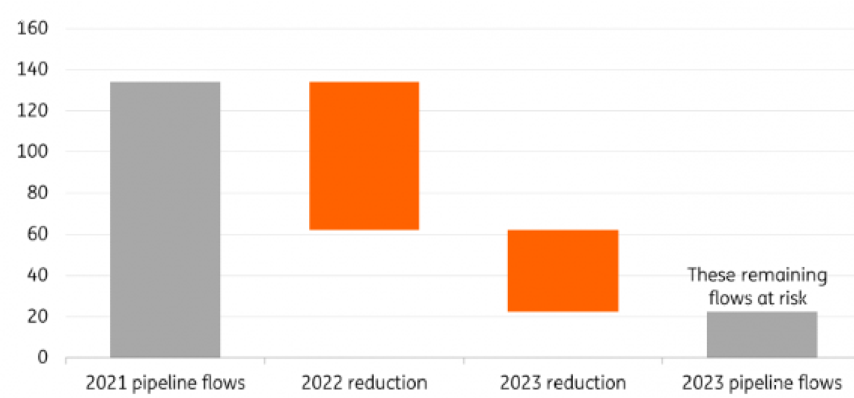
Europe will struggle to get through next winter so easily. Russian pipeline gas flows have fallen significantly this year and half the capacity to move gas was destroyed by explosions in the two main Nord Stream gas pipelines on September 26 that can't be repaired.

End of year data show that pipeline flows from Russia to Europe have fallen by around 50% y/y to roughly 58 bcm. And, obviously, these flows have declined progressively as we moved through the year with reduced flows via Ukraine and Nord Stream.

In November daily Russian gas flows to the EU were down around 80% y/y as only the Ukrainian and TurkStream pipelines were working. Assuming that Russian gas flows remain at current levels throughout 2023 (via Ukraine and TurkStream only), annual Russian pipeline gas to the EU could contract by a further 60% y/y to around 23 bcm in 2023. And analysts say there is a very real risk that the remaining flows via Ukraine and TurkStream will be halted as well in 2023.

In the current environment it is difficult to see a recovery in Russian pipeline flows to Europe. The one option for increasing the flows is to reopen the 33 bcm Yamal-Europe pipeline that runs between Russia and Germany via Poland. Flows through Ukraine could also in theory be increased. But Poland is an implacable foe of Russia and the war in Ukraine shows no sign of abating.

Russian pipeline flows to the EU (bcm)




Source: ENTSO-G, European Commission, ING Research

## Limited LNG supply growth

The liquefied natural gas (LNG) market has helped Europe significantly this year refill its tanks with record inflows – mostly from the US. LNG imports into the EU over October grew by almost 70% y/y, with volumes exceeding 9 bcm.

However, there are constraints to how much more LNG Europe can import. There are reports that LNG carriers are queuing for spots at regasification units in December, as Europe's LNG infrastructure is limited and largely was maxed out near the end of the year. This highlights the lack of regas capacity in Europe at the moment. This queue of LNG carriers could also be partly due to market players wanting to take advantage of the significant contango in the front end of the TTF curve.

The EU has seen the start-up of a fair amount of regasification capacity in the form of floating storage regasification units (FSRUs) over the second half of this year. The Netherlands, Germany, Finland/Estonia have or are in the process of starting up operations at these FSRUs with a combined capacity in the region of 23-27 bcm. Germany is expected to bring a further 15 bcm of regas capacity online early in 2023. This will help with some of the infrastructure constraints Europe is facing, but the issue is also around global LNG supply and the limited capacity which is expected to start next year.

Global LNG export capacity was set to grow by around 19 bcm in 2023, driven by the US, Russia and Mauritania. However, following Russia's invasion of Ukraine and the sanctions which have followed, it is likely that the start-up of Russian capacity is likely to be delayed. Russian capacity makes up for 46% of the total new capacity expected next year. Therefore we could see just 10.5 bcm of new supply capacity.

The other issue for the EU is competition for LNG. This year, weak Chinese LNG demand has been a blessing for Europe. LNG imports from the world's largest buyer were down 22% y/y over the first 10 months of the year. This would have been due to the higher price environment as well as the demand impact from Covid-related lockdowns throughout the year. However, if we see a recovery in Chinese demand next year, Europe will have to compete more aggressively for supply.

## Cold winter

How the energy crisis in Europe plays out will depend heavily on how cold the winter is.

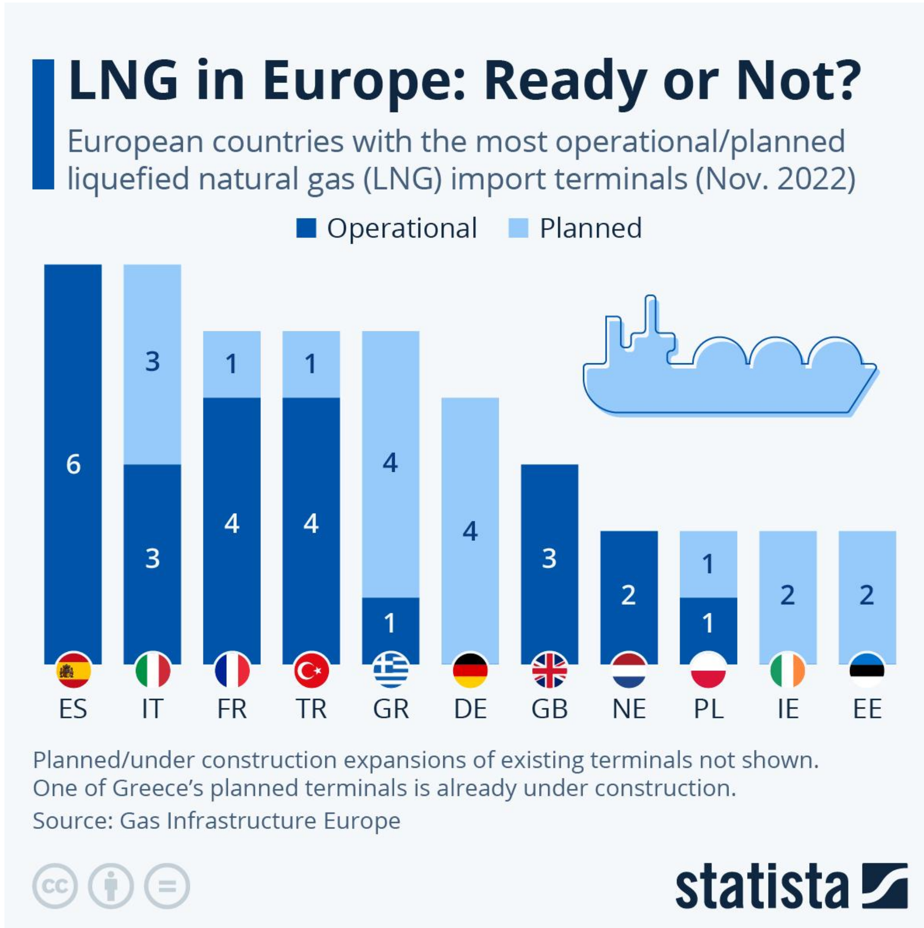
December in Northern Europe will be colder than the climatic norm, Bloomberg reported in December, citing weather forecasts. If the Arctic anticyclone turns out to be deep and blocking, there will be almost no wind. Consequently the generation of electricity from wind farms will be under threat and the need for gas generation will increase.

This means a severe test for the EU energy system, given that gas supplies from Russia are now carried only along one line through Ukraine and along the TurkStream – amounting to no more than 70 bcm. This is noticeably less than the total daily consumption of Germany alone.

The fact is that traders have good reasons not to lift gas from storage facilities, *Kommersant* writes. First, many companies filled their storage facilities at peak prices, when gas cost under $3,000 per thousand cubic metres, and they would like to sell it no cheaper. Secondly, companies are afraid of difficulties with filling UGS facilities next summer. LNG, oriented to Europe, is still sufficient, and it is still more expensive than in Asia.

Gazprom closely monitors the dynamics of stocks in European UGSFs – as of November 29, 3.3% of the stockpiled volume was withdrawn from them. "The load on UGS facilities in Europe in the current autumn-winter period will be higher than in previous years, due to the changed logistics and sources of gas supply to the European market," the Russian concern notes.

A cold winter in Europe is good for Gazprom: the more gas Europe takes away now, the more expensive it will have to be replaced in 2023. Bloomberg forecasts prices in the $1,000-$2,000 per mcm range for another year, especially with price-driven European subsidies and limited LNG supply. For 11 months, Gazprom has reduced exports to non-CIS countries by 44.5%, but gas prices in Europe are now four times higher than last year.




In order to get through the 2023/24 winter comfortably, there will have to be continued demand destruction once again. This will have to be either a result of market forces (prices needing to trade higher to reduce demand) or EU-mandated demand cuts (the 15% voluntary demand cut at the moment ends in March 2023). While Europe should be able to scrape through the 2023/24 winter if current Russian gas flows continue, it is much more challenging if remaining Russian gas flows come to a full stop.

## Gas price cap & gas shortage in 2023

EU member countries have been working on policies to try to soften the hit from higher natural gas prices. These include joint gas purchases, temporarily capping the TTF natural gas benchmark, and the setting up of a new LNG benchmark, which the Commission believes will be a better reflection of actual prices.

However, how effective these measures will be is still questionable. Capping the TTF benchmark increases the risk that we see more of the trade moving to the over-the-counter market, which will be excluded from the cap. This in turn would reduce liquidity on European natural gas exchanges and also reduce transparency in these markets.

It appears as though the Commission will set this cap well above the market rate which suggests that they only want to cap prices in an extreme situation, where high prices (similar to levels seen in August) are sustained. Furthermore, the longer-term goal of setting up a new benchmark is not going to solve the issue of bottlenecks in European gas infrastructure. TTF is trading at a premium to LNG prices because of the bottlenecks in LNG regasification capacity and pipeline infrastructure. At the end of the day, the only viable long-term solution for Europe is increasing supply and removing some of the bottlenecks facing the industry.

Europe's gas storage sites were filled to 95% of capacity as the heating season started in November 2022, putting them five percentage points above the five-year average. But high storage levels, a drop in gas prices as a gas glut built due to the lack of spare storage space, and unusually mild temperatures "should not lead to overly optimistic conclusions about the future," the IEA said.

If Russian gas supply to Europe is halted completely, and if Chinese LNG imports ramp up, the IEA estimates that there will be a 30 bcm supply-demand gap for Europe, at a time when the continent will urgently need to restock for the following winter. This gap could represent nearly half of the gas needed to fill storage facilities to 95% of capacity by the start of the 2023 heating season.

IEA executive director Fatih Birol said: "When we look at the latest trends and likely developments in global and European gas markets, we see that Europe is set to face an even sterner challenge next winter."

Governments need to carry out "immediate action," Birol said, "to speed up improvements in energy efficiency and accelerate the deployment of renewables and heat pumps – and other steps to structurally reduce gas demand."

In the short to medium term, there is little optimism about the world's ability to solve the energy crisis, nor about the prospect of lower energy prices – due to interference with markets.

Despite high prices, oil and gas companies have curtailed capital expenditures and drilling, choosing to distribute cash to shareholders. Why invest when there is so much interference from environmentalists, politicians, even activist-appointed board members? Oil and gas companies are legitimately concerned that they may end up with stranded assets – oil and gas that will not be sold, just stuck in the ground.

It appears likely that energy prices will remain high for at least 4-5 years, even if there is a recession, because hydrocarbon-based energy still accounts for 84% of global energy supply; alternatives appear incapable of taking up the slack sufficiently quickly and are constrained by supply of key minerals (copper, aluminium, battery metals, etc.). Bringing new gas, oil or nuclear projects on stream is capital intensive and takes at least 4-5 years.

### 15% reduction in EU gas consumption

Given the likelihood of another energy crisis next winter and the limited supplies of gas available given the infrastructure constraints, one of few courses of action left available to Europe is to tackle the demand side of the equation. The EU adopted a plan to reduce consumption by 15% in July.

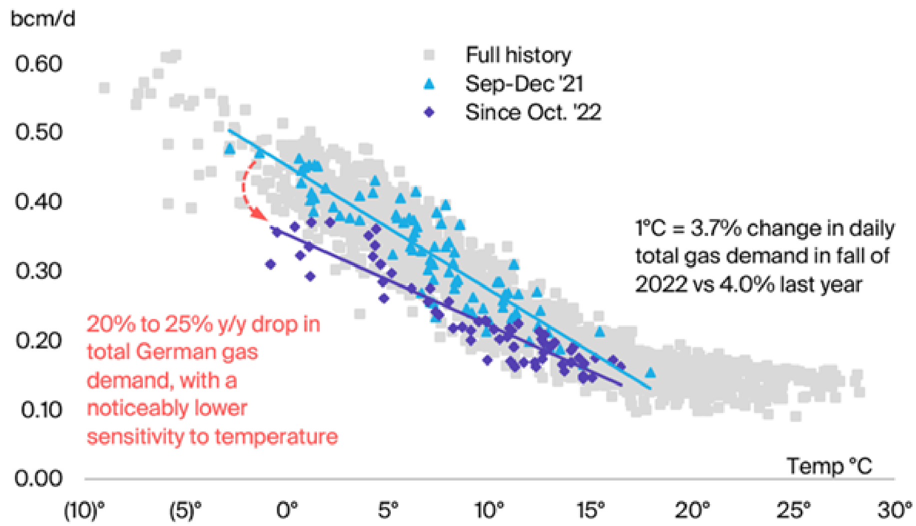
**Germany's ability to cut winter gas demand appears real, down c20% y/y as of December.** Faced with the loss of much of its Russian gas supply and a sharp energy crisis, in July EU member states agreed to reduce gas demand by 15% by winter, while Germany targeted a more ambitious 20% cut.

BCS GM analysis shows that Germany appears to have handily exceeded its 15% reduction goal. The country's total annual gas demand is typically around 90 bcm, with about 60% of that coming in the winter months of November through March. As can be seen in the chart above, gas consumption has dropped noticeably this fall and early winter vs the same period last year at any given temperature. Summer base load demand was also notably lower (c25%) in 2022 as compared to 2021.

**Demand reduction may help offset loss of Russian imports or a cold winter.** In other words, it appears that Germany may be able to reduce gas demand in the gas year of July 2022-June 2023 by perhaps 18-20 bcm, a significant portion of the 50 bcm of gas it typically imports from Russia in any given year. If we extrapolate this to broader Europe, a 20% fall in demand for a full year could imply a demand reduction of some 100 bcm, very close to the c90 bcm drop analysts expect for Russian exports to Europe and Turkey for 2022.

Alternatively, as each 1°C of temperature drop below 15°C increases gas demand by c3.7%, the gain in efficiencies could compensate for a winter substantially colder than last year. Finally, analysts note that these efficiency gains were doubtlessly not easily achieved: much of the savings probably came as German consumers, faced with unaffordable energy bills, simply set their thermostat at temperatures well below comfort level as temperatures have dropped.

German total gas demand vs temperature




Source: Tradinghub.eu, ENTSOG, wunderground.com, BCS

## • Energy embargo

**Following the launch of the EU oil embargo on importing Russian oil on December 5** most analysts agree that Russia can find new buyers for its orphaned oil, but also that production will be cut by around 1mn bpd.

In the base scenario of Oxford Economics, Russia will manage to redirect most of the crude that it used to sell to the EU to other destinations (China, India, Turkey and others) after December 5. In this scenario, Russia's total oil production and exports fall by 0.4mn bpd in Q4 2022, a further 1mn bpd in Q1 2023, and then remain flat until the end of 2024.

The brunt of the EU embargo to hit in Q1 2023, with its second phase covering petroleum products coming into force in early February.

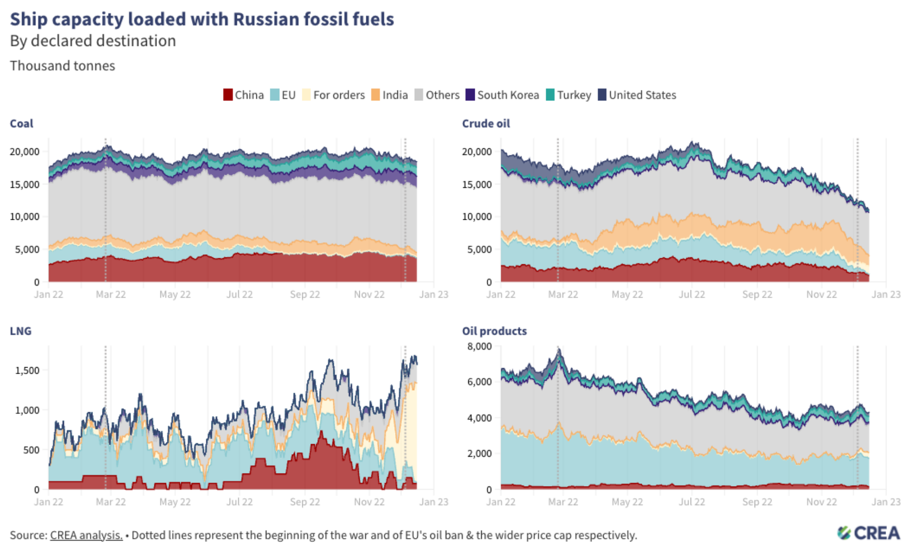
India and China do not have much interest in buying more petroleum products from Russia. They have substantial refining capacity and prefer to buy deeply discounted Russian crude and then sell oil products on the global market.

This practice will continue after December 5, as the EU has clarified that oil products produced in a third country from Russian crude won't be covered by its sanctions.

For at least a couple of years, the government can comfortably rely on its fiscal cushion to cover some of its deficit, with the remainder financed with local borrowing. Even in the "extreme" scenario when Russia cuts its oil exports by 40% next year, there should be enough money in the National Welfare Fund

(NWF) to cover the budget deficit for a few years.

**In January, before the start of the military conflict, deliveries to the EU accounted for 85% of the total volume of Urals sea shipments** – 5.16mn tonnes out of 6mn tonnes, and in September – only 24% (1.78mn tonnes out of 7.4mn tonnes).




India increased purchases of Urals from zero at the beginning of the year to just over 40% by early autumn, while Turkey's rose from less than 5% to 21%. In January-September 2022, India increased its purchases of Russian oil (not only Urals, but also the ESPO mixture transported to the port of Kozmino via the East Siberia-Pacific Ocean pipeline) by eight times, up to 20.5mn tonnes, according to Indian customs statistics.

According to Chinese customs, China purchased almost 72mn tonnes of Russian oil over the same period, compared with 65.7mn tonnes in the same period a year earlier.

India, China and Turkey increased their exports of Russian crude oil by 1.2mn barrels during the summer per day, practically compensating for the reduction in supplies from Russia to Europe.

However, by December 5, when the European embargo came into force, Moscow had to redirect about 1.1mn barrels more. to other destinations, writes the Oil & Gas Journal.

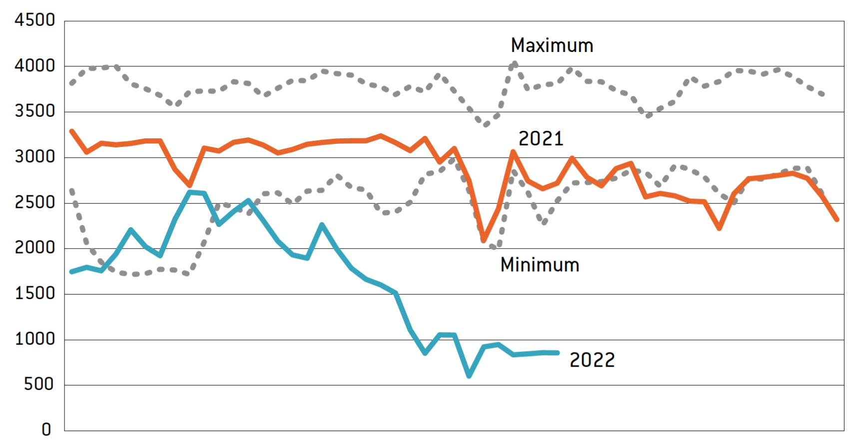
Nevertheless, the Russian authorities are unlikely to agree to reduce oil production, as it is both costly and not so easy – it is necessary to mothball the wells, says Pavel Verevkin, an investment strategist at Alor Broker. As a last resort, during overproduction, oil can be stored in reserve storage facilities, which can be built additionally, he admits.

**EU ministers agreed on a gas price cap.** Energy ministers of the European Union member states on December 19 have reached a consensus on a cap for natural gas prices, according to the spokesperson for the Czech Republic's EU presidency, Dmitrij Černikov. Reuters reported, citing an official document, that the new policy states that a cap on gas prices will be implemented at €180 per megawatt hour (MWh).

Previously the EU discussed the upper limit of the gas price cap at €220. Several nations, including Europe's biggest economy, Germany, have opposed the idea of any cap, saying it could make it harder to secure supplies. However, Belgium, Italy, and Poland see it as a way to protect consumers and the economy from the shock of high energy prices.

Under a compromise put forward by the Czech Republic, which holds the EU's rotating presidency, the cap kicks in  if prices exceed €180 per MWh for five days on a month-ahead contract at the TTF hub in the Netherlands, reported Reuters. At the same time, the TTF price, which serves as the European benchmark, must be €35 higher than the reference price for liquefied gas, based on numerous existing estimates of LNG prices, for the cap to work.

**Figure 21: EU and UK natural gas imports from Russia**



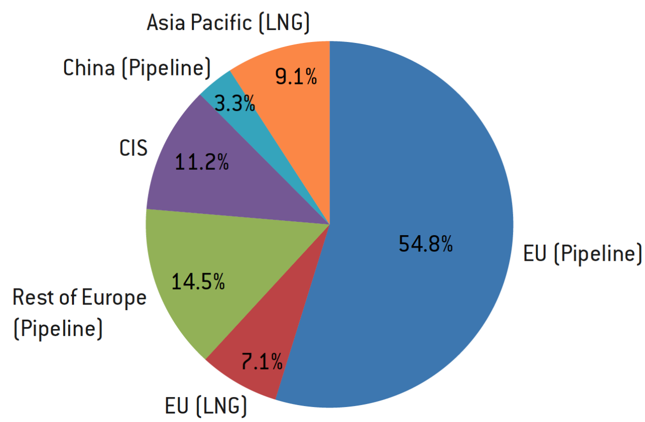

Source: Bruegel; see https://www.bruegel.org/dataset/european-natural-gas-imports.

**Russia will need to close a sizable portion of its gas-export infrastructure as around 60% of its gas exports go west to the EU and UK.** These cannot easily be redirected quickly, with new pipelines to China and Asia needed at least five years to build and more likely a decade as the offtake agreements need to be put in place first, and that is a long, slow process.

Like sea-borne oil, Russia has some ability to redirect LNG exports away from the EU. Unlike oil, the overwhelming majority of the EU's imports are via pipeline and Russia will not be able to redirect these flows, which accounted for 55% of exports in 2021.

In the future, it is possible that the EU will again import gas from Russia. If so, these flows should be subject to explicit price and volume restrictions agreed at EU level.

**Figure 22: Russia natual gas exports (2021)**




Source: BP.

**Canada, the United States and Australia have banned all imports of Russian oil,** while the United Kingdom has announced a phase-down to zero at the end of 2022. Given the limited dependence of these countries on Russia (between 1% and 5% of demand), these announcements have no significant impact.

**The Czech Republic will continue receiving Russian oil through the Druzhba pipeline's southern branch for three more years**, after which the country will switch to the Transalpine (TAL) Pipeline, online newswire Idnes reported late on Wednesday quoting Prime Minister Petr Fiala. "Czechia will be dependent on oil supplies through the Russian pipeline Druzhba for three more years. But starting from 2025, supplies of strategic crude will be secured through the Transalpine Pipeline TAL, whose capacity will be expanded significantly," Fiala said as quoted by Idnes. Expansion of TAL's capacity to 7–8mn tonnes per year of oil has already been approved by the management of the companies that operate the pipeline. The expansion should be finished in two years and cost around CZK1.2-1.6bn, or $51-68mn, Fiala said.

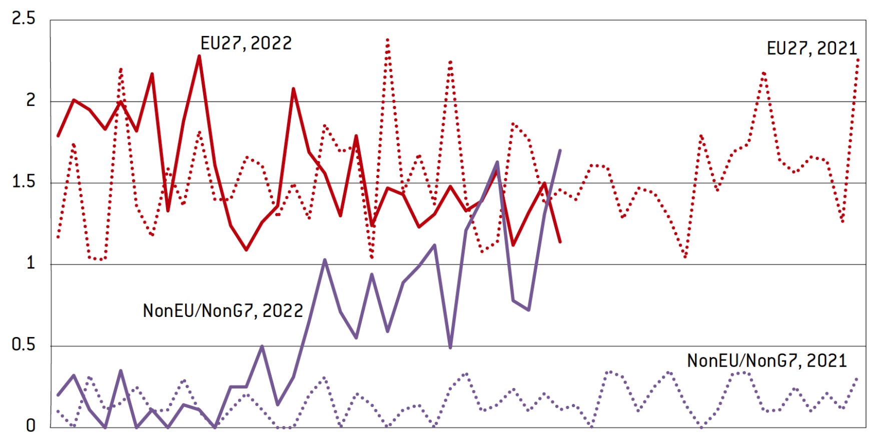
**The European Union, which is much more dependent on Russian oil imports** (25% of demand), agreed only at the end of May 2022 to stop seaborne imports of Russian oil at the end of the year. Only at the start of 2023 will more than 90% of Russia's previous oil exports to the EU be banned.

Nevertheless, the EU's decision is very significant and will have major repercussions for Russia's role as a main oil exporter in the medium and longer term.

In the meantime, however, Russia has continued to earn substantial oil revenues. Crude oil exports from Russia's western and Arctic ports have remained strong. These ports historically served European consumers, and whether flows can be redirected to non-EU countries will be pivotal in determining the ultimate impact of sanctions.

Though there has been a small reduction in Russian exports to the EU, other countries including India and China have increased Russian oil purchases, more than compensating for the loss of the EU market. These countries were buying Russian oil at a significant discount to global prices, starting at $35 but falling to around $8 as volumes increased. As European demand disappears, third countries will find it easier to negotiate discounts in 2023.

**Figure 20: Weekly Russian crude oil exports from western ports**




Source: Bruegel Russian crude oil tracker, https://www.bruegel.org/dataset/russian-crude-oil-tracker.

Russia also exports oil via pipeline to Europe and China, and via eastern ports. These flows are still not subject to any planned sanctions, but only represent a small share of total exports.

**The embargo will target oil tankers carrying Russian crude and refined products**. Over 90% of the world's oil tankers are insured via the International Group of P&I Clubs, a London-based association of insurers. In agreement with the UK, the EU also introduced in its sixth package of sanctions against Russia, a ban on insurance for ships carrying Russian oil from the start of 2023.

EU operators will be prohibited from insuring and financing the transport, in particular through maritime routes, of Russian oil to third countries. As finding new sources of insurance is difficult and costly, this measure would have a meaningful impact on Russian exports to non-EU countries.

Fearful of the potential repercussions of this measure on global oil market, the United States pushed – most notably at the G7 level – to replace the EU's blanket insurance ban with a mechanism linked to an oil price cap, under which insurance would be offered to ships transporting Russian oil only when the price cap is respected.

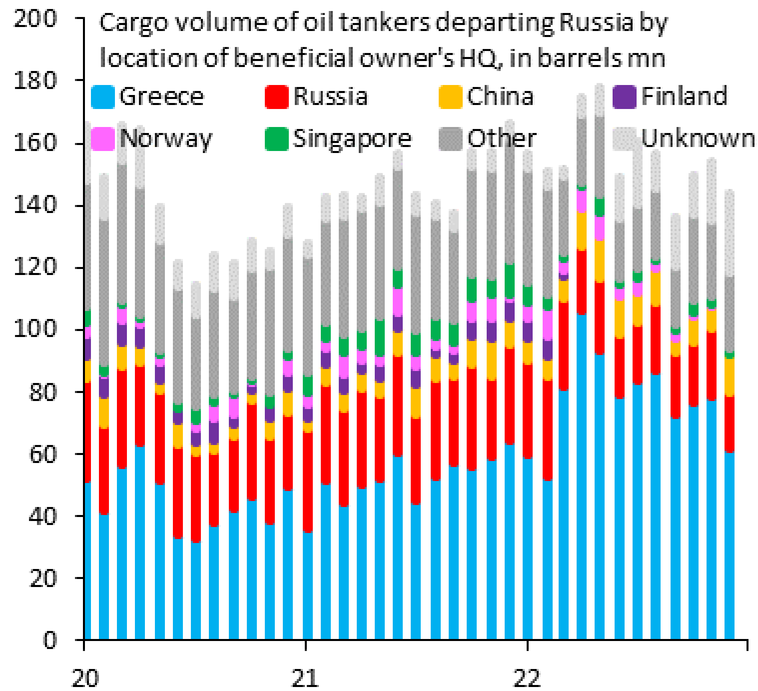
The G7 agreed this price cap in September. Since then, the EU has modified its previous oil sanction scheme and introduced – with its eighth package – the option for EU operators to insure oil tankers transporting to third countries Russian oil traded below the agreed price cap.

The aim of this move, representing a watering-down of the EU previous oil sanction scheme, is that Russian oil will continue flowing at lower prices, removing windfall profits, but avoiding the worst global economic consequences – if it works.

**The jury remains out on how effective the oil price cap scheme will be**. Russia owns around 82 vessels out of the 7,200 that transport oil worldwide; the G7 and allies own about 4,700 vessels. To redirect to the East/Global South, Russia would need to increase the number of its tankers by roughly 4 times.

But some EU shipowners will have to sell tankers if they are not allowed to transport Russian crude. And Chinese shipowners will buy those vessels to carry Russian crude. Russia was already reportedly assembling a "ghost armada" of tankers, booked using shell companies and intermediaries to hide their origin, taking a leaf out of the Iranian playbook, which successfully avoided much of the oil export ban imposed on it by the US.

**Russia is building a "shadow" fleet of oil tankers (grey) to circumvent the G7 price cap**. Putin is using dollars earned from energy exports right now to buy the "shadow" tankers, particularly from Greek shipping companies, says Institute of International Finance (IIF).




**Russia currently exports natural gas from eastern fields to China through the Power of Siberia 1 pipeline**. Western fields, which serve European markets, are not connected to this export route and cannot be redirected to China.

The new Power of Siberia 2 pipeline is being discussed now and will connect the two fields and eventually enable Russia to redirect flows eastwards when it comes online in 2030.

Meanwhile, without European customers, Russia will be forced to close production sites at significant long-term capital cost. Export revenues from gas will dry up. Attempts to diversify export routes by building new liquified natural gas export capacity are hindered by lack of access Western technology, and in any case will take years.

The commercial conditions in the Chinese market are much worse for Russia than those in the European market. Before the Ukraine war, Russia was estimated to charge $3 per million British thermal units (mmBtu) for deliveries to China via the Power of Siberia pipeline, while the estimated charge for deliveries to Europe was $10-$25/mmBtu. The best long-term case for Russia’s gas business is to serve China as the dominant buyer. In the short-run, the situation is much more dire.

Europe has so far managed to replace significant volumes of gas supplies that previously came from Russia with LNG.

# • Sanctions

**The EU cannot confiscate the frozen $300bn in assets of the Russian central bank because of the international principle of state immunity,** The Wall Street Journal reported on December 4. The European Commission said this principle made confiscation impossible, but the EU might establish a fund for management of liquid assets and allocate profit from investment in reconstruction of Ukraine.

The Commission also said that the EU has no information on the share of central bank's assets in various member states and on the share of liquid assets. The EU will insist on Russia's granting part of the frozen assets to Ukraine in the framework of a peace treaty. The EC outlined the ninth package of sanctions in December that includes another 200 names of individuals to the Specially Designated Nationals and Blocked Persons (SDN) list that includes Russian armed forces, individual officers and defence companies, members of parliament, ministers, governors and political parties, among others, European Commission President Ursula von der Leyen said.

Three more Russian banks will also be added to the list of sanctioned banks including the Russian Regional Development Bank.

Sanctions on products will also be expanded targeting export controls and restrictions for dual-use goods, including chemicals, nerve agents, electronics and IT components that could be used by the Russian war machine.

Russia does not have a chip sector of its own and relies heavily on the import of semiconductors and microchips from the West. Its partners like China do produce chips of their own, but only lower quality chips. The higher quality chips they also produce are made under licence from their US intellectual property owners and are covered by US sanctions and cannot be exported to Russia.

EC President Ursula Von der Leyen said that the new sanctions are aimed at cutting Russia off from technology to produce drones in particular, banning the direct exports of drone engines to Russia and the export to any third countries, such as Iran, which could supply drones to Russia.

Four more Russia controlled TV stations will be taken off air and blocked on the internet.

New economic measures will also be brought against the Russian energy and mining sector, including a ban on new mining investments in Russia. Mining and metals have been largely excluded from the sanctions regime so far as Russia remains deeply integrated in the international metals market.

Significant leakage to the sanctions regime remains as the year came to an end. The ninth package contains little of substance, although the mining and metal sanctions could be significant if implemented. The most significant sanctions to be implemented in the fourth quarter was the oil price cap scheme, but at the time of writing it remains to be seen how effective that will be.

The failure of the efforts to sanction Russia's coal exports is indicative of the increasing difficulties the West has on imposing sanctions on Russia. Russian exports of coal soared in the last months of 2022 to fresh highs after the EU softened sanctions on European shipping companies, allowing them to carry goods worldwide shortly after a ban was imposed in August as part of the fifth package of sanctions.

The fifth package was imposed in April. It was the first package to target Russia's energy business, as it banned European companies from seaborne shipments of coal and went into effect on August 10.

The leading EU shipping companies, particularly Greek firms, have resisted the ban on shipping Russian goods as it makes up such a large part of their business. The Institute of International Finance (IIF) found in a survey that since the war started not only has Greek shipping failed to reduce its involvement with Russia, but its market share in transporting Russian goods by sea has risen from 35% to 55%, when reflagging and other dodges to obscure the ownership of ships are taken into account.

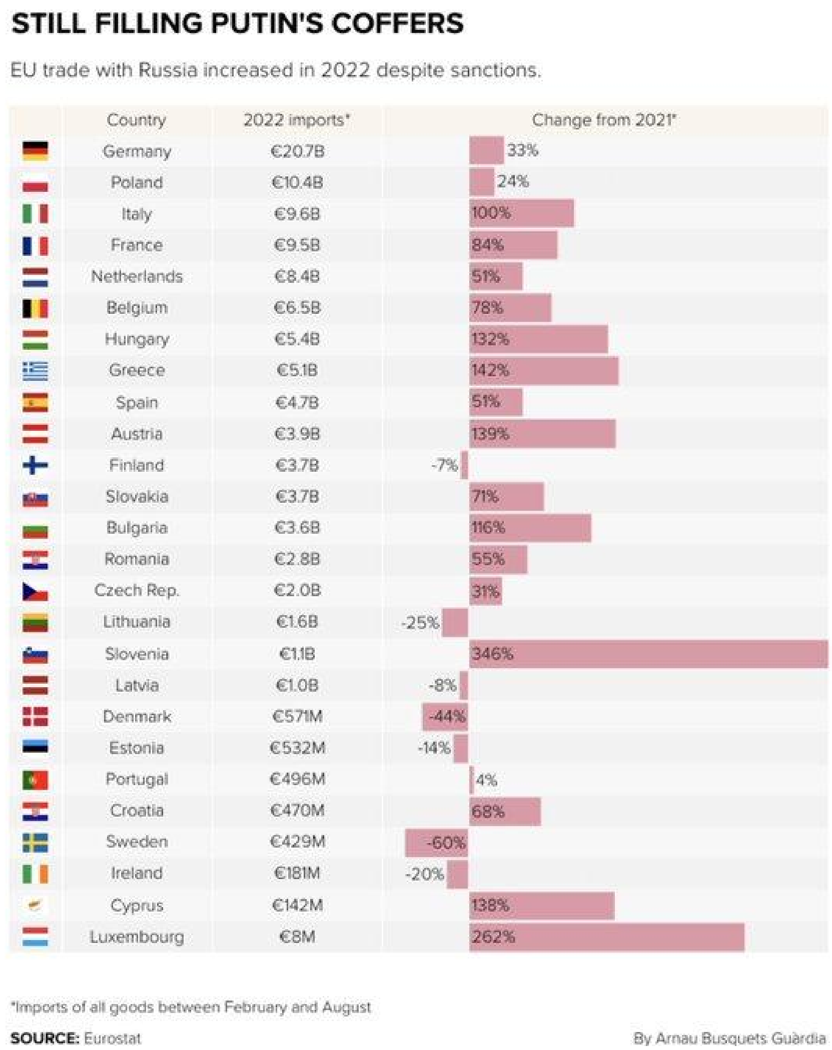
Lobbying by the Greek shipping industry and others led the EU to soften the fifth package of sanctions. The ban on the transport of Russian coal and other products was amended in September and allowed for the provision of services like shipping, financing and insurance needed to transfer coal and other products by ship to destinations outside the EU in order to "alleviate the energy and food crises worldwide." Since then, Russia's seaborne coal exports have risen to their highest levels on record as the winter arrives, with many of the shipments going to Asia. Previously the EU was heavily dependent on imports of Russian coal, which accounted for 46.7% of all EU imports of solid fuel, according to Eurostat.

The volume of Russian coal exports in October rose to 16.6mn tonnes, just under the level in June, which was the highest volume since 2017, according to analytics firm Kpler. Exports have slipped a bit since then, in line with normal seasonal volatility, Port News reports.

Like Russia's oil exports, the softening of the shipping sanctions on Russian coal producers has allowed them to successfully redirect their business to Asia and represents more sanctions leakage.

# • Trade

**The trade turnover with the EU increased dramatically in 2022 despite the sanctions regime.** However, the increase in dollar and euro terms was largely driven by soaring energy and commodity prices as the volume of goods traded fell heavily in the period. What the chart below shows is the pain inflicted on Europe by the war in Ukraine and the price shock induced by the war. Those countries that saw the biggest increases like Slovenia are also some of those that are most dependent on the imports of Russian gas. Others like Spain and Portugal that saw the smallest increases are amongst the least dependent.




**Russia's most important economic partners. This applies to both financial markets and trade relations.**

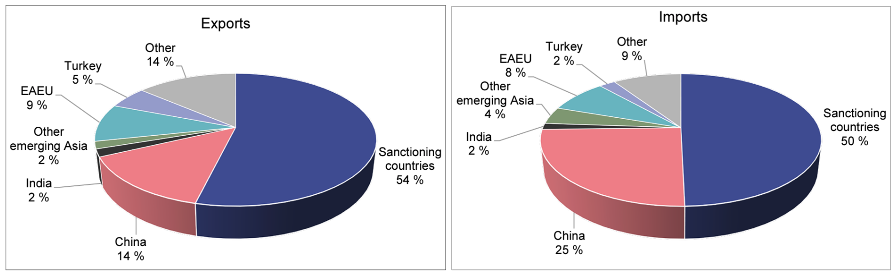
As the countries imposing sanctions on Russia have dominated Russia's external economic relations, it is very difficult for Russia to compensate for the loss of these financial and trade flows.

Countries that joined in international sanctions on Russia in spring 2022 accounted for about half of Russia's goods trade in 2021.

Among non-sanctioning countries, Russia's biggest trading partner by far was China.

Other large trading partners not joining the sanctions regime included Turkey and India. The member countries of the Russian-led Eurasian Economic Union (EAEU) accounted for about 10% of Russia's trade.

**Figure 1.** Geographic distribution of Russia's goods trade in 2021.




Source: Russian Customs.

**Russia's foreign trade surplus almost doubled on the year to $269.8bn in January-November** thanks to high prices for key exports and a decrease of the cost of imports, the central bank said on December 9.

Exports will continue to decline from $598bn in 2022 to $445bn in 2025, while imports will climb from $331bn to $370bn over the same period, leaving Russia with a healthy trade surplus.

**The sanctions regime has been very leaky, as too many countries still rely on Russia for essential inputs.** The US maintains high volumes of imported Russian fertilisers, metals and uranium, despite the sanctions for Russia's full-scale military invasion of Ukraine, according to a report by Forbes.

As covered in detail by *bne IntelliNews*, although Russian metallurgy is buckling under wartime economic realities, some Russian metals are deeply embedded in global markets and are hard to sanction.

In July, the US exempted strategic metals such as palladium, rhodium, nickel and titanium, as well as crude aluminium, from a hike of import tariffs.

The US imported $189mn of Russian rough palladium in October, the highest monthly number since $230mn in February 2022. For 10M22 over $1bn of palladium has been bought, with Russia accounting for over 30% of total US palladium imports.

The US also imported Russian platinum worth $35mn and rhodium worth $30m in October, up from zero and $7mn in the previous month respectively.

Shipments of Russian mineral fertilisers shipments to the US in October increased by 10% month on month and 29% year on year to $183mn, according to Forbes. Russian fertilisers' exports to the US increased to $1.36bn for 10M22 overall, already beating the $1.3bn for all of 2021.

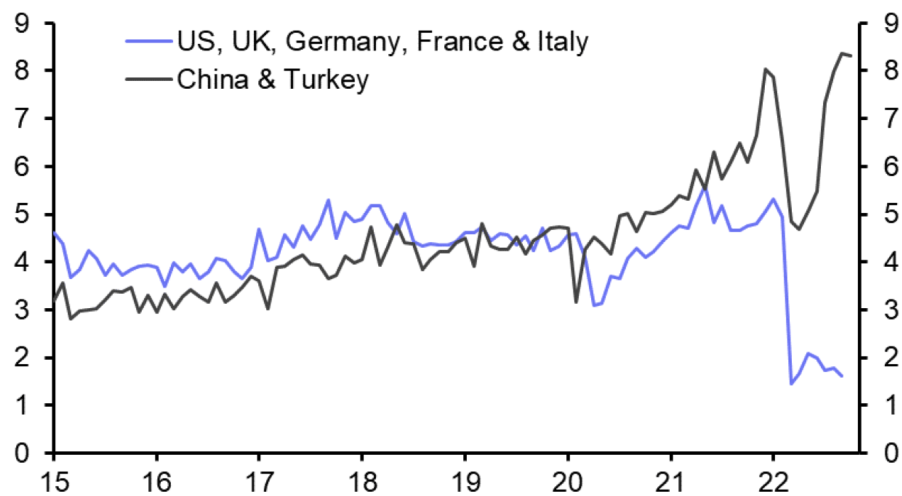
**The value of Russian goods imports declined sharply after Russia's invasion of Ukraine**, but has since recovered slightly. The value of Russian imports in September was still nearly 30% below the prewar level.

The decline in imports reflects diminished demand in Russia, restrictions on exports to Russia and payments to Russia imposed by sanctioning countries, and unilateral decisions by numerous foreign companies to suspend or stop doing business altogether with Russia.

Russian imports from most countries have generally declined, but there is variation across countries. The value of imports from the EU in September was about half the pre-war level. Imports from India were down 5% in September. Imports from China were up by 3% in September (and 5% October). The value of Russian imports from Turkey was more than double the pre-war level in September, while imports from Kazakhstan were up by 50%.

Russia's import structure by countries has also changed notably since the war started. The share of sanctioning countries has declined from over 50% in 2021 to about 30% in July 2022. China's share climbed to 36% by July, but apparently it has risen further in the following months. The share of CIS countries has doubled to about 20%. Turkey's share has also more than doubled, but it was still less than 5% in July.

## Chart 13: Russia Imports (SA, $bn)




**There is a perception that sanctions have not been effective in doing economic harm to Russia and therefore have not undermined its capacity to continue the war in Ukraine, but the sanctions are effective; it's just they are slow-acting.**

The view is grounded in unrealistic expectations as it ignores the fact that an emerging market with a commodity-driven annual current account surplus of more than $120bn in 2021 prior to sanctions is largely shielded from dramatic external shocks.

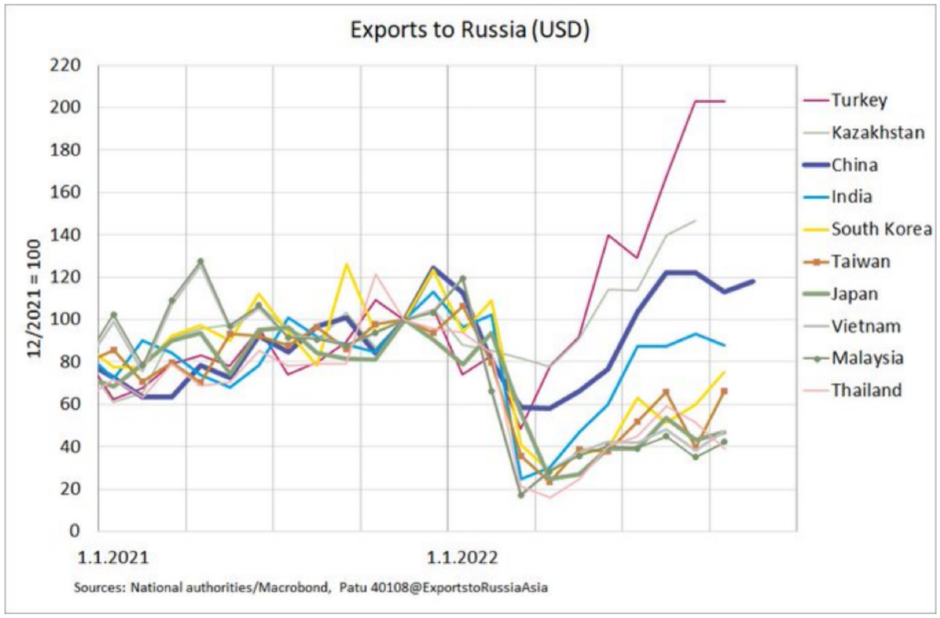
**The second factor behind the increase in Russia's current account balance is the decline in Russian imports**. Official trade statistics from the country's authorities do not extend beyond February 2022, but imports in subsequent months can be estimated by looking at data from Russia's main trading partners. By this measure, Russia's imports fell by roughly $8.5bn in March 2022 compared to the previous month, and by somewhat more in April, before recovering from May to August. The bounce back has been driven by imports from China, which have returned to pre-war levels, and by soaring imports from Belarus and Turkey.

The total for the first half of 2022 will likely be $8bn to $9bn lower than in the first half of 2021 (or a 6% drop y/y). While it is reasonable to assume that Russia's imports will continue to expand as it finds alternative sources for key goods, the 2022 total could be $20bn lower than 2021.

Together with the export price effect, the reduction in imports could therefore mean a roughly $140bn shift in the trade balance in Russia's favour – an amount that cannot be cancelled out by sanctions on Russian exports.

**As commodity prices are likely to remain high until the end of 2022, a Russian current account surplus of close to $240bn is anticipated for the full year.** Relatively high prices will also continue to support the current account in 2023, despite the EU embargo on crude oil and petroleum products and despite Russia's decision to cut natural gas flows to Europe. Bruegel estimates a surplus of around $100bn in 2023 – a substantial drop compared to 2022, but nevertheless robust current account dynamics.

"Such numbers might suggest sanctions are failing to change foreign-exchange dynamics for the time being and may be counterproductive. However, the combination of a large and likely persistent fall in Russian imports, and the permanent decoupling of European economies from Russian energy supplies, will have significant negative consequences for the Russian economy in the medium to long run," Bruegel said in a report.




**Russia's bilateral trade with the European Union in 2021 reached €257bn, with €158bn of those being Russian exports** to the bloc. According to **Eurostat**, Russia-EU trade reached €171.4bn in the 7M 2022, which if averaged at similar volumes for the entire year would give a total 2022 figure of €293.8bn – an increase on 2021 levels.

**The trade turnover between Russia and China soared by 32% y/y to a record-high $172.4bn between January and November 2022,** the Main General Customs Administration of China reported on December 7. In the 11 months of 2022, China's export to Russia gained 13.4%, reaching some $67.3bn. Imports of Russian goods and services surged by 47.5%, to $105.07bn in the reported period. Russia's bilateral trade with China in 2021 reached $141bn (same value as the Euro today), of which Russian exports to China reached $68bn. Compounded over the full year, that would indicate an increase in trade of some $184.6bn, meaning an additional $43.6bn over 2021, with Russian exports rising to $113.2bn, an increase of $18.86bn.

Trade turnover between Russia and China in the energy sector grew by 64% in monetary terms and by 10% in physical terms, Russian Deputy Prime Minister Alexander Novak said on November 18.

**Russia's bilateral trade with India reached $13bn during the Indian fiscal year 2021/21** (India runs a March-April fiscal period), taking us to April 2022. Of this, according to COMTRADE, Russia's exports amounted to $9.13bn. Since then, according to the Indian Ministry of Commerce & Industry, in the 5M period May-September 2022, Russia-India bilateral trade amounted to $18.2bn, of which Russian exports were about $16.38bn – India has been buying a lot of cheap oil from Russia.

**India plans to double trade with Russia, using the rupee for settlements,** The Indian Express reported on November 13 citing a protocol of a high-level meeting that took place in September. Earlier in the week, the Indian government permitted use of the rupee in international transactions. According to the protocol, the Trade Ministry said it was ready to support the initiative of a 100% increase of the trade amount with Russia soon, and the rupee use in the payments was seen as an additional stimulus.

The Russian authorities, having wasted RUB3 trillion on import substitution programmes, continue to look for alternative sources of imports of high-tech parts, without which the industry is worthless. Despite the government's best efforts at import substitution, in some segments imports remain at 100%, or slightly less by the beginning of the war in 2022: the share of Russian radio-electronic products in the domestic market was only 12%, equipment for the production of baby food – 3%, automatic transmissions for cars – 0%.

Now the Russian Ministry of Industry and Trade is looking for these parts in India – the department sent a list of more than 500 goods to the country that Russia would like to purchase, from ignition coils for cars to fire extinguishers for aircraft.

There are 14 pages in the "Indian" list of the Ministry of Industry and Trade. It includes automotive engine parts (ignition coils and oil pumps), bumpers, seat belts, infotainment systems, aircraft fuel systems, aircraft fire extinguishers, life jackets and aircraft tyres. The list also included raw materials for the production of paper, paper bags, consumer packaging, yarn and dyes.

India's total imports from Russia expanded sixfold from February 24 to November 2022, from $5.89 billion to $29.3 billion. The volume of Indian exports to Russia is 15 times less.

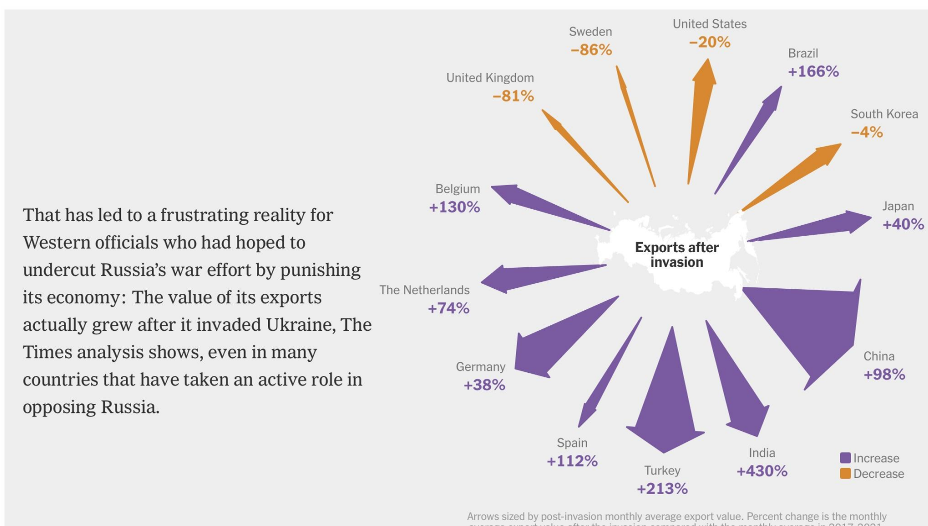
**The Eurasian Economic Union (EAEU) is a trade bloc that comprises Russia, Armenia, Belarus, Kazakhstan and Kyrgyzstan.** Russian imports from the EAEU countries increased by 32% in 9 months of 2022 and reached $22.8bn. The volume of mutual trade in the reporting period exceeded $57bn, the press service of the Russian Ministry of Economic Development said.

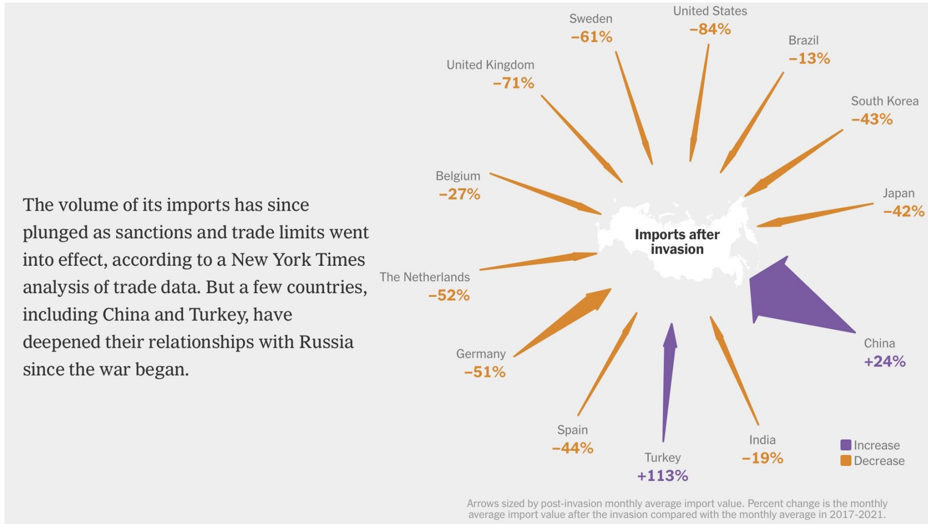
"There is a significant increase in Russian imports from the EAEU countries. For 9 months of 2022, the increase was 32% (up to $22.8bn). This is a clear example of redirected trade flows and the replacement of goods from unfriendly countries with products from the Union countries," Deputy Minister of Economic Development Dmitry Volvach was quoted by the press service.

In 2021, Russia-EEU trade amounted to $72.61bn, of which Russian exports to the EAEU member countries amounted to $45.3bn. By 7M 2022, that had risen to $74.2bn, meaning a compounded 2022 total could reach $127.2bn, with Russia’s exports achieving about $99.6bn of this. That will indicate rises of $54.59bn in volume and $54.3bn in exports over the year.

**Russia and Kazakhstan recorded a record-high trade turnover by the end of this year,** Prime Minister of Russia Mikhail Mishustin said on November 28 at the meeting with President of Kazakhstan Kassym-Jomart Tokayev. "Despite the challenging geopolitical situation and things far from being simple also in the international market situation, our trade turnover gained more than 10% in January-October of this year as compared to the like period of 2021, and totalled [over] $22bn, which is a record-high figure. If this trend continues until the year-end, I am confident we will achieve new record-breaking figures by the volume of interaction in our mutual trade," Mishustin said. Countries are accelerating existing joint projects in machine-building, the nuclear power industry, agriculture and digital development, the Russian Prime Minister said, referring to bilateral economic relations.

**Iran hopes to ramp up trade turnover with Russia to $5bn in the foreseeable future,** Deputy Foreign Minister Mehdi Safari said at a meeting with the Russian delegation headed by President of the Chamber of Commerce and Industry Sergey Katyrin.






**Turkey's bilateral trade with Russia in 2021 reached about $30bn, with some $23bn** of this being Russian exports to Turkey. The two countries engage in a great deal of energy trade; however, Russia's need for parallel imports is also feeding an increase in bilateral trade. In the 10M 2022, Turkey-Russia bilateral trade is about $60bn, of which Russian exports to Turkiye amount to $25.99bn. Compounded over the whole of 2022, this would indicate a total trade volume of some $72bn and Russian exports of about $31.19bn, increases of $42bn and $8.2bn respectively.

**President of Azerbaijan Ilham Aliyev is satisfied with the growth of trade turnover with Russia,** and he sees prospects for its growth. According to the leader, there is potential in the area of cargo transportation as well. "We are very glad, of course, that mutual trade is returning to the pre-pandemic level, and I am confident that the dynamics will persist," he said. Aliyev welcomed Russian Prime Minister Mikhail Mishustin, who was paying a visit to Baku, at his Zagulba residence near the Caspian Sea on November 18.

The trade turnover between Azerbaijan and Russia in January-October 2022 rose by 22.3% y/y and amounted to $2.868bn, the State Customs Committee of Azerbaijan announced.

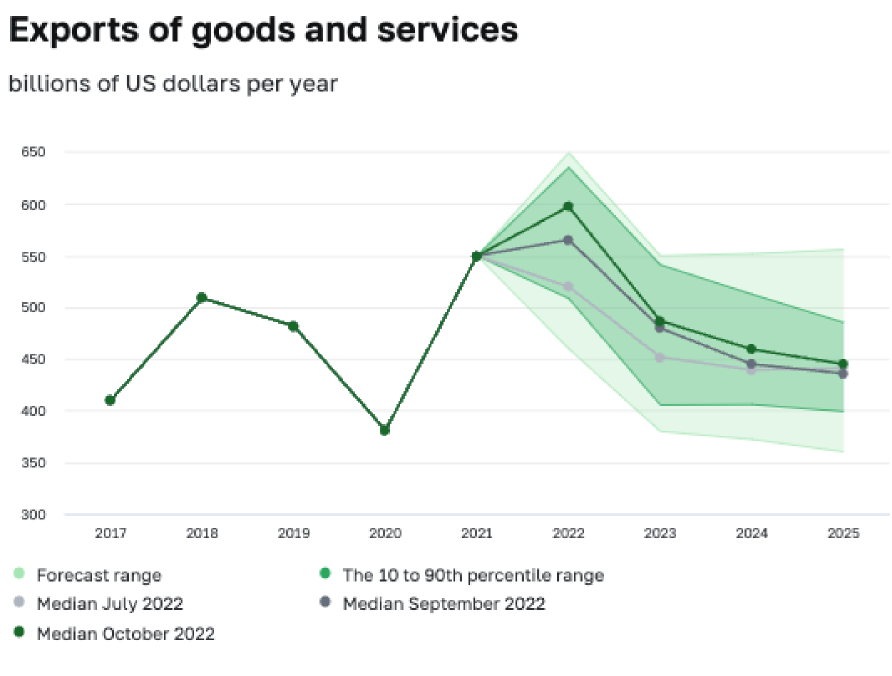
According to the report, the export of Azerbaijani products to Russia in January-October amounted to $719.1mn (+3.2% y/y); imports of goods from Russia were $2.149bn (+30.4% y/y).

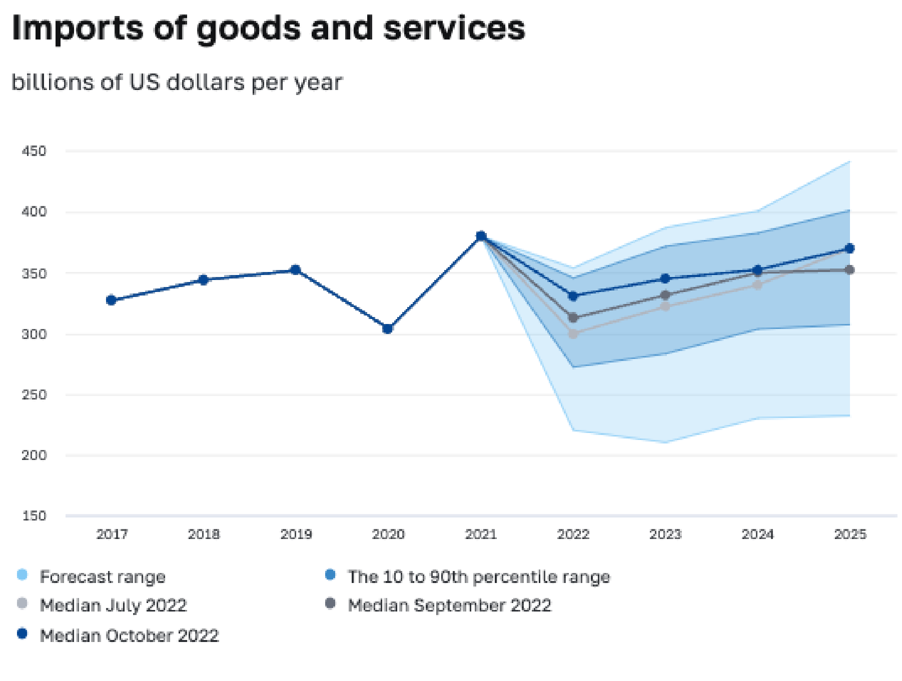
Russia ranked third among Azerbaijan's trading partners in the reporting period, after Italy and Turkey. The share of trade operations with Russia during this period accounted for 6.19% of the total foreign trade turnover of the country.

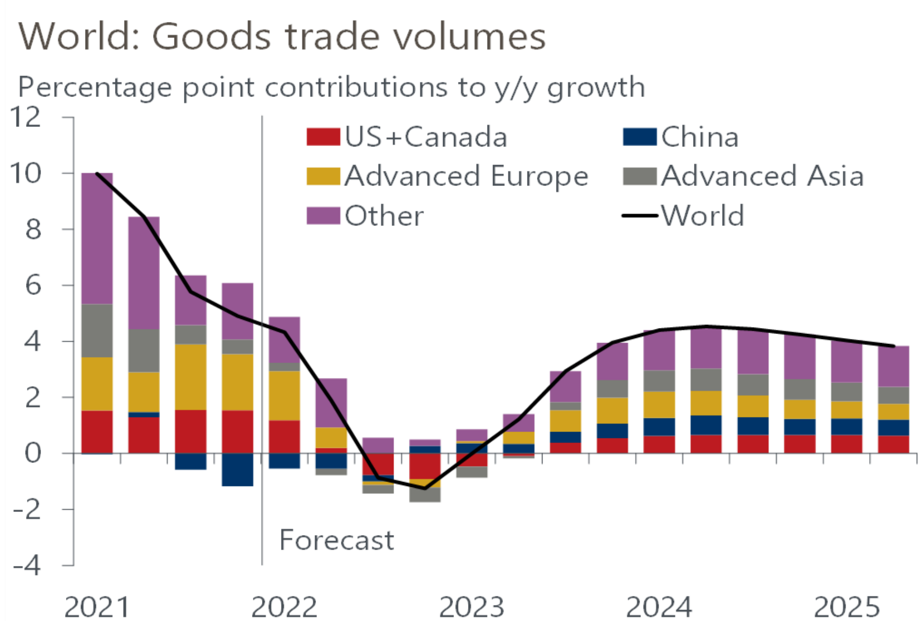
In 2021, the trade turnover between Azerbaijan and Russia increased by

12.1% y/y and came to $2.99bn. The share of trade operations with Russia last year amounted to 8.83% of the total foreign trade turnover of Azerbaijan.

**Trade turnover between Russia and Belarus increased by 9% in the first nine months of 2021 and reached $30.5bn**, Russia's Deputy Economic Development Minister Dmitry Volvach said on Wednesday. In the first nine months of the year the volume of Russian imports from Belarus grew by 14.6%, he said as quoted by his ministry's press service.






## • CPI

**Inflation in Russia registered 11.9% in 2022**, which is below the projected level, Economic Development Minister Maxim Reshetnikov said at a government meeting headed by President Vladimir Putin in January.

"Inflation [in Russia] was below 12% by the end of the year, 11.9% to be precise," he said.

Annual inflation in Russia is expected below the targeted level of 4% in Q2 2023, Reshetnikov noted.

"We assume that annual inflation will go down considerably by the end of Q1 as the May peak of prices will go out of the base, and in Q2 we will see figures most likely even lower than the 4% target, at least for some time," he said.

Earlier reports said that the Economic Development Ministry predicted inflation of 12% in 2022, and of 5.5% in 2023.

**The lower growth rates of consumer prices, seasonally adjusted, conceal the effect of several diverging factors** at the end of 2022. On the one hand, prices for many goods and services including a certain foreign currency component were still on a downward trajectory in the fourth quarter of 2022. The high yield of many crops and the growth in production in livestock are both having a disinflationary impact.

On the other hand, prices in foreign currency terms for many imported consumer products, especially of European origin, are up significantly.

This comes as a result of sanctions, as well as of higher costs and more complex logistics, triggering a reduction in imports.

Persistently high growth of prices in commercial services is in evidence, where prices in spring were unperturbed by the temporary sharp weakening of the ruble.

As one-off disinflationary factors fade out, combined with the intensification of pro-inflation factors related to the labour market, a changing structure of the economy, and growing consumer confidence, fluctuations in inflation will emerge. The monetary policy stance aims to return inflation to 4% in 2024, the CBR said in December.

**Russia's consumer price inflation continued to accelerate in November to come in close to 0.4% m/m and 12% y/y.**

As followed by *bne IntelliNews*, at the latest policy meeting the Central Bank of Russia (CBR) argued that the most recent escalation of Russia's military invasion of Ukraine and the mobilisation will rather have a disinflationary effect through subdued demand. This was confirmed in October data as weekly inflation numbers remained stable.

The acceleration in weekly price growth in November was mainly driven by the core basket of goods and services posting its strongest advance since July. "It is still too early to tell whether this was a change in trend or a one-off event (perhaps driven by the end of the discounts offered during the Black Friday sales week)," Sberbank CIB commented.

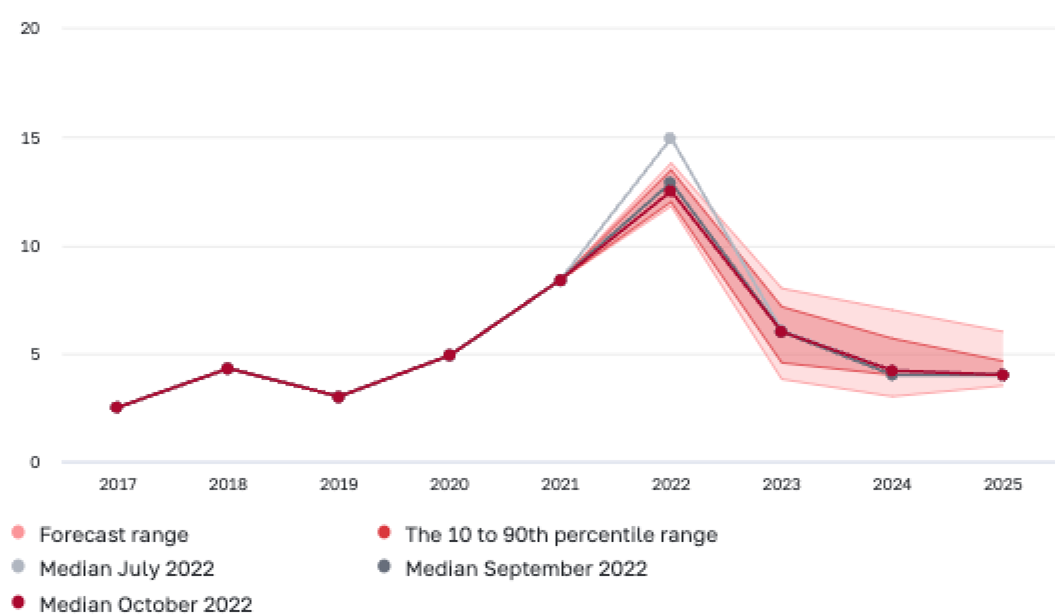
Both Sberbank CIB and RenCap expect inflation to accelerate further in December (to 12%-12.5% y/y) due to the indexation of housing tariffs and stronger demand amid increased budget expenditures that seasonally peak at the end of the year.

The board of the CBR has resolved to maintain the key interest rate flat at 7.5% at the policy meeting of October 28, making no key rate cut for the first time in six months, as anticipated by the market.

**Analysts expect inflation to slow to 6% in 2023, return to near 4% in 2024** and keep to the target of the CBR thereafter. Meanwhile, the forecast for 2024 is slightly raised (by 0.2 pp to 4.2%), remaining in the July-September range.

## CPI

%, Dec. to Dec. of the previous year




# • CBR monetary rates

**Russia's prime rate ended 2022 at 7.5% and will be cut to 7.1% in 2023, falling to 6% by 2025,** as Inflation declines from 12.5% in 2022 to 4% over the forecast period, according to the CBR.

**The CBR's decision to maintain the key rate flat at 7.5% on December 17 came as no surprise, with market participants unanimously expecting this no change decision.** We believe that taking a pause can be viewed as an appropriate strategy, when the economy is entering a new spiral of geopolitical risks (oil and refined oil embargo) and when the domestic economic situation is even less certain: weak household demand is accompanied by high government spending.

The decision was supported by flat inflationary expectations. Amid increased uncertainty, when inflation indicators have become more volatile (but primarily reflecting supply-side factors), taking a pause is viewed as a stabilising move, which may anchor inflationary expectations amid the ruble weakening and growing government expenditures.

The central bank expects to return to a neutral key rate, which the regulator still sees at 5-6% in 2025, Chairwoman Elvira Nabiullina said on November 9.

"The key rate will be at a level that will gradually reduce inflation, this means it will be a little higher than the neutral range for some time," Nabiullina told at a meeting of the State Duma lower house committees that considered the main directions of a unified state monetary policy for 2023 and 2024-2025.

"We expect to return to a neutral rate in 2025," she added.

The CBR governor said that the Russian banking system has withstood shocks of this year well and retains the potential for lending and a margin of safety.

According to Nabiullina, lending is now growing at a good pace, especially corporate lending demonstrating that structural transformation of the economy is going on, enterprises use credit to adapt to new conditions, to replace external debt. She also said that the central bank plans to use regulatory incentives to allow banks to meet the increased credit needs of business.

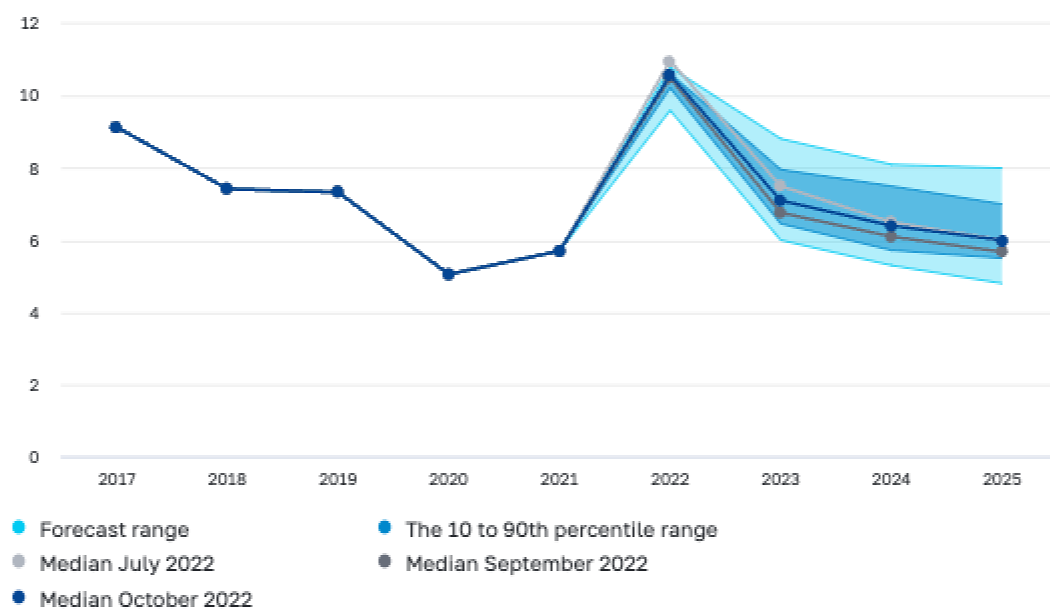
**The soft inflation dynamics at the end of 2022 are welcomed by the central bank, but will not be enough to offset Nabuillina's concerns about inflation risks stemming from the mobilisation of reservists**. In its "talking trends" bulletin issued in December the central bank said that "the disinflationary effect on the consumer market was short-lived" and that the loss of labour supply will result in an "intensification of pro-inflation forces" further ahead. Nabiullina is not known as the "most conservative central banker in the world" for nothing.

"The sanctions are very powerful. We should not downplay their impact both on the Russian and international economy. We cannot get isolated from their impact," she said.

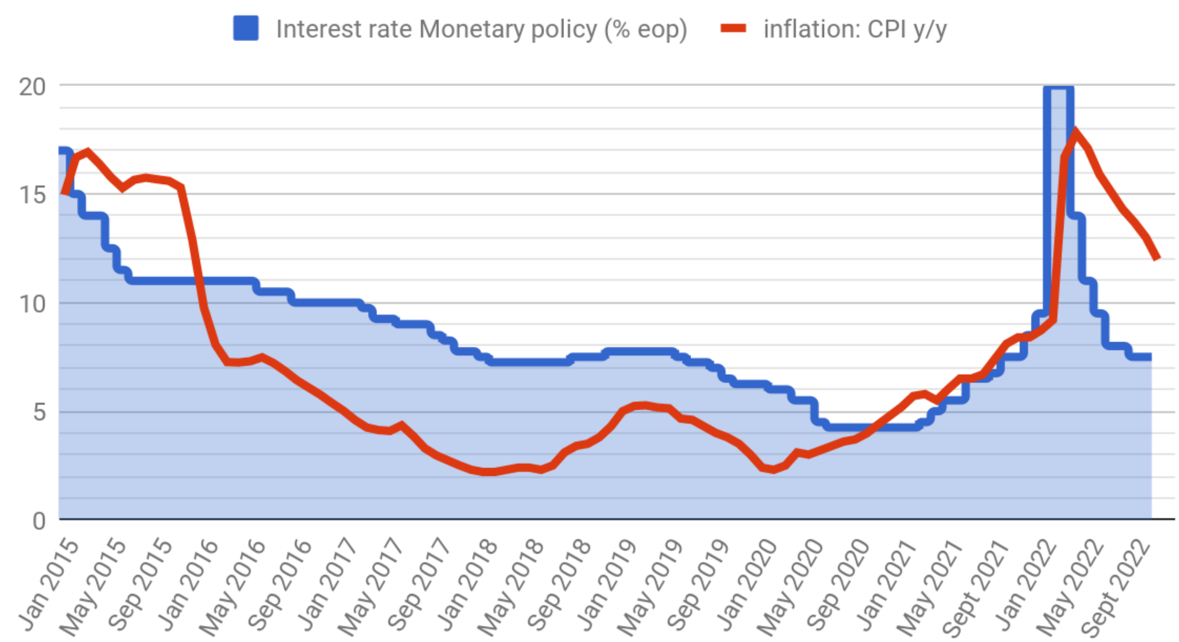
She also said that the situation and the balance of risks in the world economy have shifted to a more severe scenario in recent months, if not to a global crisis.

## Key rate

% per annum, average for the year, including weekends




## Russia monetary policy rate vs inflation CPI



# • FX & capital flight

**The dollar/ruble exchange rate will weaken from RUB68.4 to the dollar in 2022 to RUB75 in 2025, according to the CBR.**

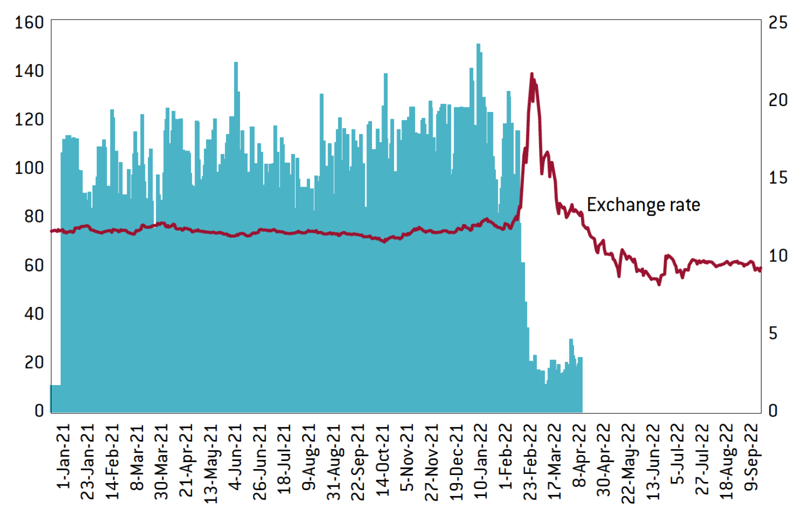
**Analysts expect a stronger ruble over the entire forecast horizon compared to the CBR's September macroeconomic survey**, with a gradual weakening trend.

Analysts forecast for 2022 – RUB68.4 per dollar, for 2023 – RUB71.4 per dollar, for 2024 – RUB74.7 per dollar.

The strongest revision is forecast for 2025 – RUB75.0 per dollar (in September – RUB79.7 per dollar).

Trading volumes in the ruble dropped significantly following the start of the war and are unlikely to recover.

**Figure 12: Ruble trading volumes fell sharply after sanctions were imposed**




Source: Bruegel based on Bank of Russia, Bloomberg.

**The surprising strength of the Russian currency has led some to conclude that the overall macro situation is strong but this is not correct, says IIF.**

Volumes transacted have dropped sharply, implying that the sanctions are working as intended, says Robin Brooks, the chief economist at the Institute of International Finance (IIF).

Immediately following the imposition of sanctions, the ruble dropped from about 70-75 to the dollar to close to 140 to the dollar. This market reaction was very short-lived; by April 2022, the exchange rate returned to below pre-invasion levels. It is now fluctuating at about RUB60 to the dollar. Two main factors have influenced this.

First, and crucially, volumes of rubles traded fell to about a third of what they were before the war. A much smaller volume of transactions implies that the price signal is both more volatile and less informative in terms of the underlying fundamentals. The reduction in volumes transacted is the result of sanctions and capital controls that stop non-residents from taking money out of the country.

Also, for an extended period, the CBR imposed strict capital controls, ordering banks not to sell foreign currency to retail clients and introducing a $10,000 cap on cash withdrawals from foreign currency-denominated retail accounts. While the cap has since been largely lifted, and Russian citizens can transfer up to $1mn per month, supplies of foreign currency are extremely limited and withdrawals can take considerable time.

Second, current account dynamics are extremely favourable because of shrinking imports and high prices for the main export goods. In addition, the central bank, starting on 28 February, required exporters to convert 80% of their revenues into rubles, before reducing the share to 50% in late May as concerns over ruble weakness and foreign exchange liquidity subsided.

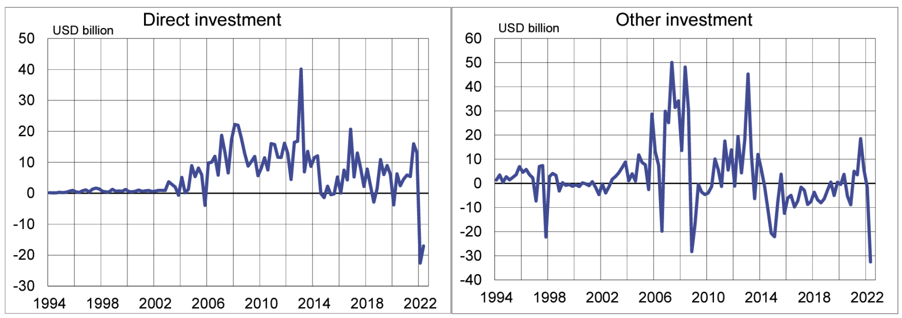
Thus the end-of-year exchange rate is not a reflection of the value of the Russian economy's fundamentals. Rather, it is a testament to the fact that financial sanctions are isolating the ruble internationally.

**Capital flight after war started has been historically large.** The net outflow of foreign capital from Russia after the invasion of Ukraine has been historically large. According to Russia's official balance of payment statistics, the net flow of inward FDI to Russia was negative by about $40bn in January-June.

The net flow of inward portfolio investment was also negative $14bn and other investment negative $34bn. Preliminary balance of payments data suggest that net capital outflows from Russia continued in 3Q22.

After the invasion, Russia rapidly imposed restrictions on capital flows with "unfriendly" countries (countries imposing sanctions on Russia). By complicating efforts of investors and companies from such countries to pull their capital out of Russia, these measures likely stemmed Russia's haemorrhaging of capital. Russia recently adopted legislation that prohibits the sale of foreign company stakes in certain financial organisations and energy-sector corporations. Even without such formal prohibitions, the exit process of companies from Russia typically took time and was costly due to such obstacles as regulatory compliance.

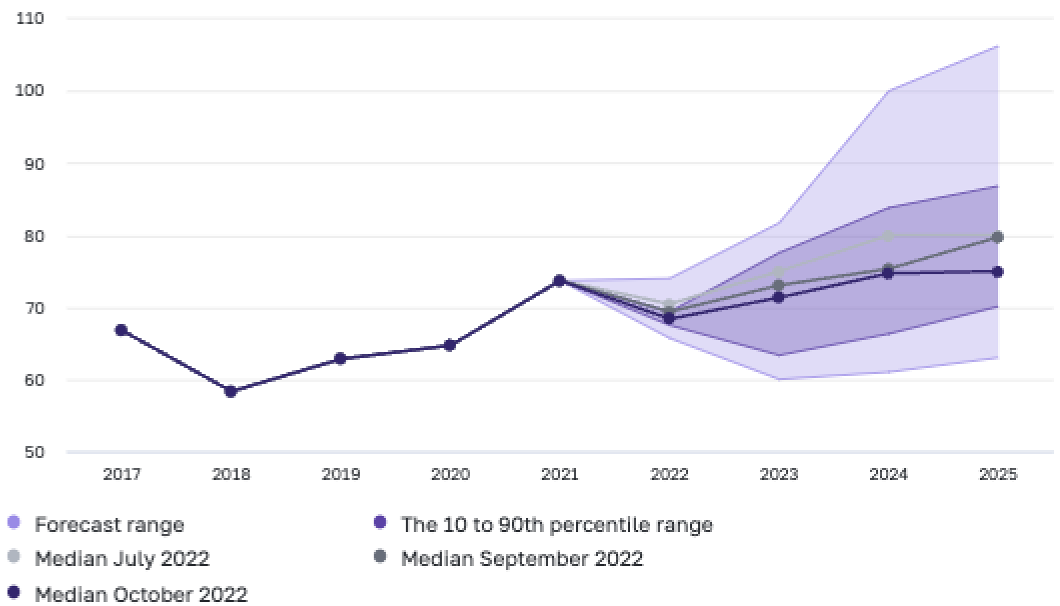
**Figure 3.** Quarterly net flows of inward investment to Russia in 1994–2022.




Source: Central Bank of Russia.

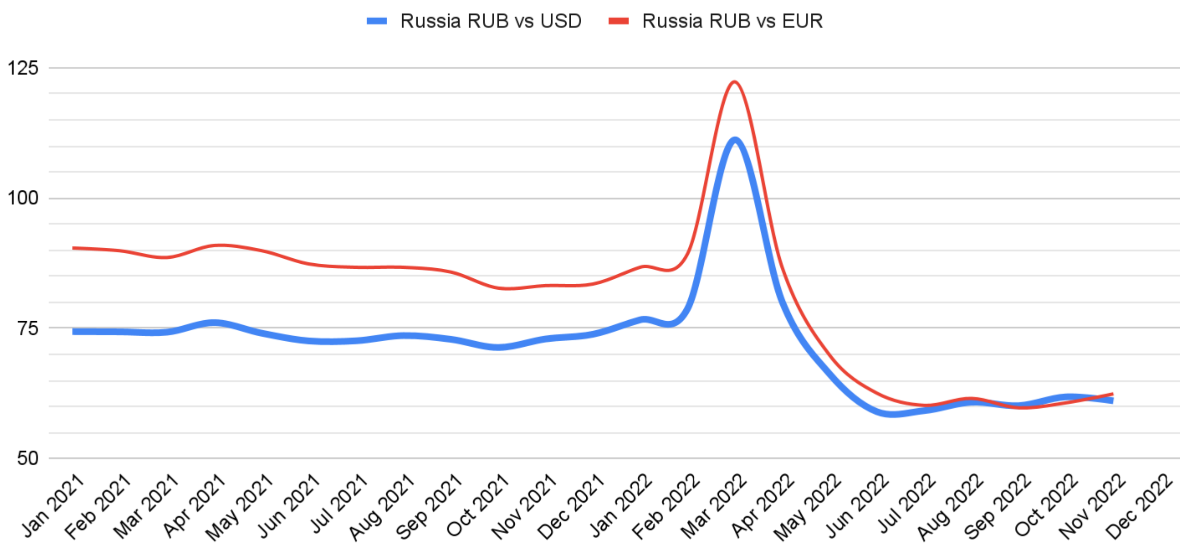
## USD / RUB rate

RUB per USD, average for the year



Russia RUB vs USD

source: CBR




# • Real incomes

**Real household earnings have been decreasing in Russia since 2016,** which has affected the families' potential long-term budgeting, First Deputy Minister of Labour and Social Security of Russia Olga Batalina said in December.

"Unfortunately, real disposable household income has continued falling since 2016, which has surely influenced the stability of financial status of families, their confidence and possibility of long-term budgeting, considering that housing improvements are one of [the] major demands of families with kids, this always being a very serious financial burden," she said.

**The real disposable income of the Russian population decreased by over 12% in the third quarter of 2022** compared to the same period of 2021. The y/y index of real disposable income saw a decrease from the previous month.

**Real incomes have fallen in most Russian regions according to RosStat**. While the national indicator (a fall of 2.4%) may not seem too serious, note two things. First, this happens after a decade of stagnating and falling incomes, and second, there are significant regional differences. While oil and gas regions (and some poorer North Caucasian regions) registered growth, the situation in regions that saw an industrial breakdown this year – including many regions that were already relatively poor to begin with – is much worse, and will likely get worse still.

Falling inflation and a strong ruble has made Russians feel a little richer than they are, but real disposable incomes are likely to shrink further in 2023.

The average wages in Russia increased to RUB61,879 per month ($994.519) in September 2022 and was briefly over $1,000 a month in dollar terms during the summer. The strength of the ruble was not lost on the FX-savvy population.

Nominal salaries have been rising at around 10% but set against the 12% inflation there has been little gain made in real incomes in 2022.

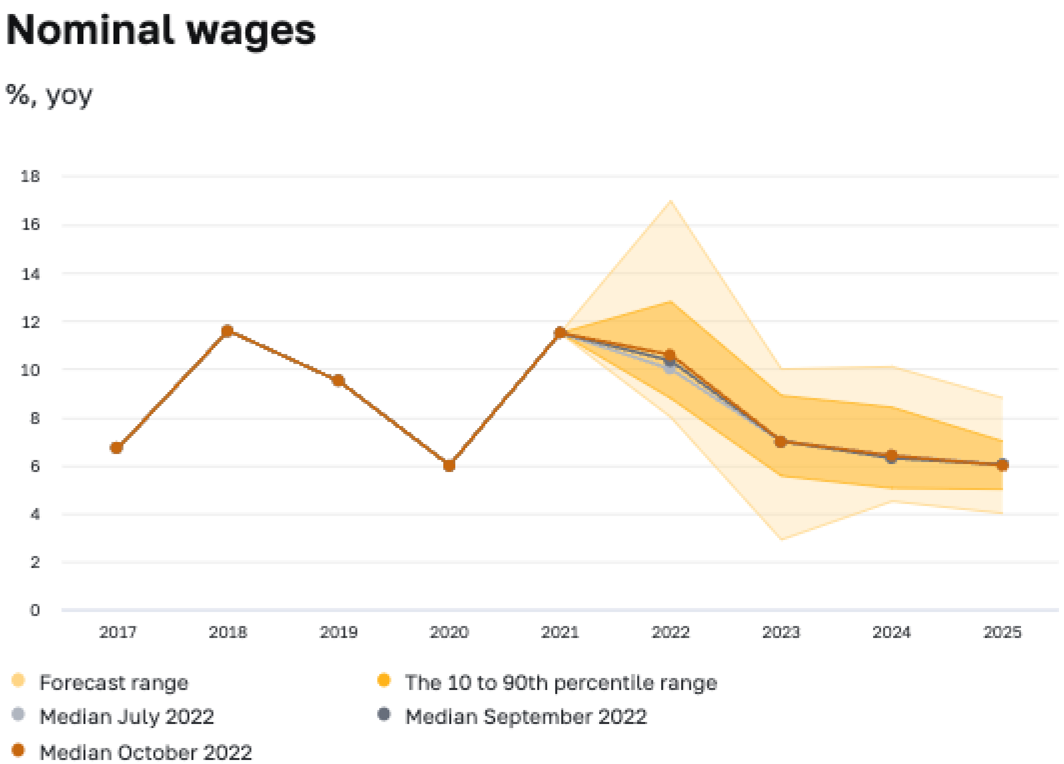
If the CBR is successful in its campaign to bring inflation rates back down to 4% by 2024 then real incomes could grow again, but as the economy is also expected to stagnate that will not necessarily feed through into an improved quality of life.

**Russian President Vladimir Putin signed a federal law that establishes a minimum wage for 2023 of RUB14,375 ($230)**.

The document was published on the official Internet portal of legal information. According to the text of the document, in 2023 the subsistence minimum for Russia as a whole per capita is set at RUB14,375, and 2024 at RUB15,049.

The increase comes at a time when for the first time in 20 years, global wage growth has not been able to outpace inflation and has fallen by an average of 0.9%, and excluding China was down by 1.4%.

The maximum decline among the regions of the world is in Eastern Europe (3.3%), where Ukraine made the largest contribution to the reduction of the indicator and could lose some 15% of its jobs, according to the ILO. By contrast, the biggest gains were recorded in the countries of Central Asia (up 2.5%) and the Asia-Pacific region (1.3%).




## • Labour

**The unemployment rate in Russia was at the minimal level of 3.7% and inflation turned out to be lower than expected**, President Vladimir Putin said at the Cabinet meeting in January. "We ended the year of 2022 with the minimal unemployment rate – 3.7% and with [a] lower inflation level than forecast," the head of state said. "An increase in the real incomes of the population should be achieved" and "the inflation downward trend should be addressed in the current economic policy," Putin noted.

**According to flash estimates in December, between mid-October and November, the Russian economy was able to overcome the short-term decline caused by partial mobilisation.**

The impact of the disinflationary effect on the consumer market was short-lived. However, over a one- to two-year horizon, workforce constraints are on course to hold back potential GDP growth, which, other things being equal, is to have a pro-inflation effect on the economy, the CBR said in a note in December.

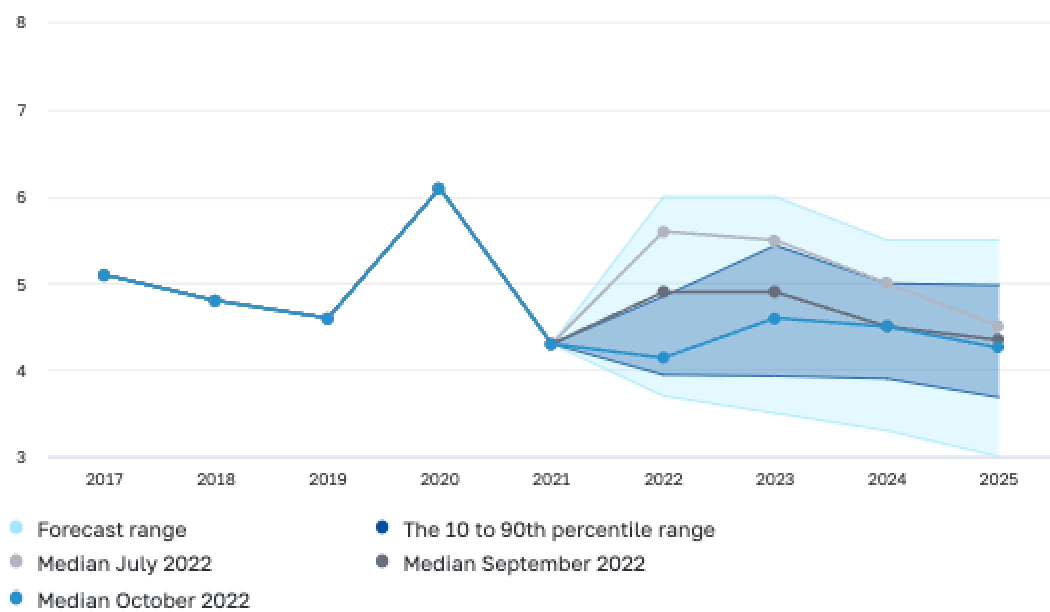
**Unemployment that remained at historic lows of just under 4% for 2022**

may increase to 5% but due to the tight labour market is not expected to change much.

At the same time, the unemployment rate in the Russian labour market remains at a record low and in the third quarter of this year amounted to only 3.8%, and was 3.9% in November.

## Unemployment rate

%, Dec, not seasonally adjusted




## • Retail

**Household spending on goods and services fell by 7% y/y in real terms in the second and third quarters**. Household purchasing power has been reduced by the spike in inflation that followed immediately from Russia's invasion of Ukraine.

Consumption has notably been affected more than just the drop in real household income, which deepened as late as in the third quarter and just to 3.4% y/y. As in previous recessions such as the covid recession of 2020, the drop in consumption partly reflects a significant shift to increased saving in households.

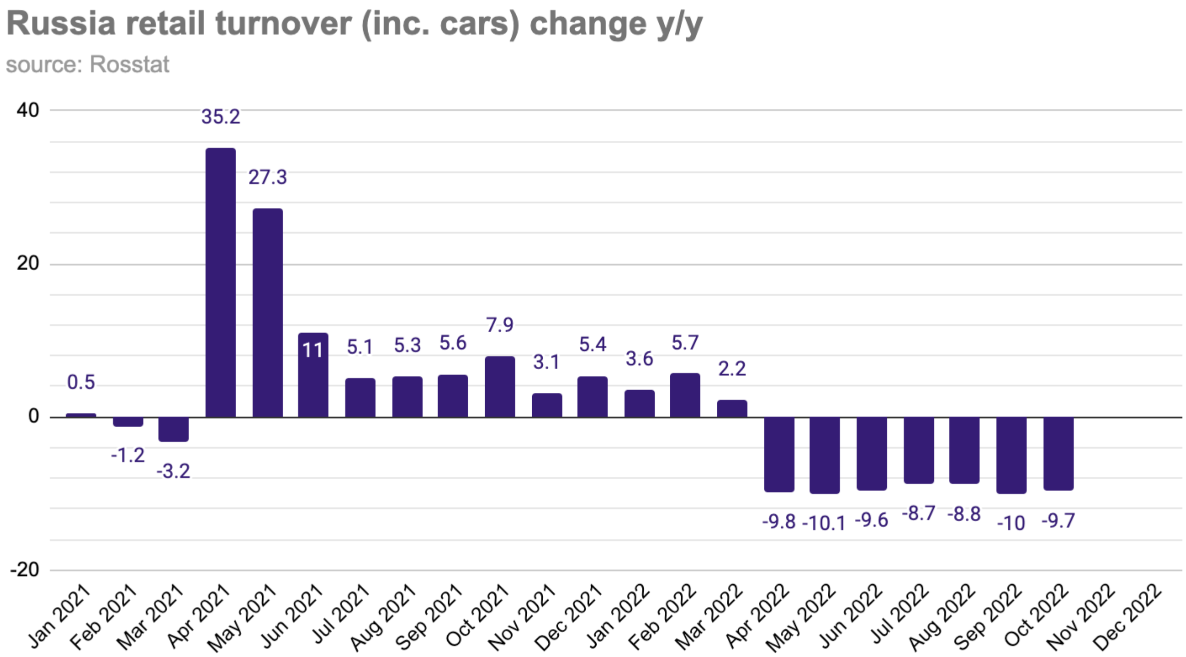
Goods purchases, which in normal years represent about 80% of household spending, have plunged even more. Retail sales, which according to RosStat account for nearly 95% of household spending on goods, have remained down by 9-10% y/y since April.

Retail sales of food items, however, have only declined by a couple of percent. In the main food sales categories, the clearest drops have been seen in fish and dairy products, while sales of meat products have remained largely unchanged. Sales of alcoholic spirits continued to rise and were up by over 7% y/y in the first nine months of this year.

In contrast, retail sales of non-food goods were down by about 15% y/y in the second and third quarters. Along with the collapse in sales of passenger cars, there have also been sizable drops in sales of household appliances and mobile phones but also construction materials and clothing. The sale of medicines continued to increase, albeit considerably slower than in the early months of this year.

Household purchases of services have held up relatively well, although their growth has slowed. Sales in services provided to households mainly by companies averaged real annual growth of less than 1% in the second and third quarters.

**Retail trade turnover in Russia continued to decline in October and decreased by almost 10% y/y reaching RUB3.5 trillion ($57.34bn).** In January-October, turnover decreased by 5.9% to RUB34.7 trillion ($568.5bn), according to the Russian State Statistics Service (RosStat). "Retail trade turnover in October amounted to RUB3.584 trillion, or 90.3% (in comparable prices) compared to the corresponding period last year, in January-October – RUB34.783 trillion, or 94.1%," the statement said. The share of large online retailers rose by 1.8 pp in October.


Russia retail turnover (inc. cars) change y/y
source: Rosstat
40
20
0
-20
35.2
27.3
11
5.1
5.3
5.6
7.9
3.1
5.4
3.6
5.7
2.2
0.5
-1.2
-3.2
-9.8
-10.1
-9.6
-8.7
-8.8
-10
-9.7
Jan 2021
Feb 2021
Mar 2021
Apr 2021
May 2021
Jun 2021
Jul 2021
Aug 2021
Sep 2021
Oct 2021
Nov 2021
Dec 2021
Jan 2022
Feb 2022
Mar 2022
Apr 2022
May 2022
Jun 2022
Jul 2022
Aug 2022
Sep 2022
Oct 2022
Nov 2022
Dec 2022

# 4.0 Budget & Debt

| Main parameters of 2021-2023 federal budget | | | | |
|---|---|---|---|---|
| | **2020** | **2021** | **2022** | **2023** |
| Revenues RUB trillion | 17.9 | 18.8 | 20.6 | 22.3 |
| Expenditures RUB trillion | 22.6 | 21.5 | 21.9 | 23.7 |
| Budget deficit RUB trillion | -4.7 | -2.8 | -1.2-1.4 | -1.2-1.4 |
| Budget deficit % GDP | -4.4 | -2.4 | -1.0-1.1 | -1.0-1.1 |
| State borrowing RUB trillion | 4.4 | 2.9 | 2.1-2.4 | 2.1-2.4 |
| Source: Ministry of Finance | | | | |

## • Federal budget 2022-2025

**Russia spent around RUB5 trillion ($78bn) on the war in Ukraine in 2022** and the main budgetary issue for 2023 is how to fund at least the same spending. Among other options, the Ministry of Finance intends to issue RUB3.5 trillion of OFZ domestic bonds to cover the bulk of the spending. It can also tap the National Welfare Fund for additional funds, but it is using its rainy day reserve sparingly, as the war could go on for several years and the ministry wants to keep something in reserve.

**The Russian budget deficit in December 2022 increased by RUB400 trillion compared to forecasts and exceeded RUB3 trillion.** The reason was due to a fall in oil revenues following the entry into force of the European oil embargo and the oil price cap scheme for Russian oil pushing down both prices and export volumes.

In the first month of 2022, oil prices remain relatively low ($80 per barrel of Brent), and Russian Urals, according to Bloomberg, is even below $40. Such a price environment threatens the budget in 2023 with even more serious problems.

The Russian budget deficit in 2022 amounted to RUB3.3 trillion, or 2.3% of GDP, Finance Minister Anton Siluanov said. This is RUB400bn, or 0.3% of GDP, more than the ministry predicted over a month ago, on December 12. At the end of September, the forecast was even more optimistic (RUB1.3 trillion, or 0.9% of GDP).

The most obvious explanation for such a sharp expansion in the hole in the Russian budget is the fall in budget oil revenues in December. There are no official data on oil and gas revenues for December, but their decline was inevitable due to the collapse in Russian oil prices against the backdrop of the EU oil embargo coming into force on December 5.

As the Ministry of Finance itself reported on January 5, in December 2022, Russian Urals oil cost an average of $50.47 per barrel, 1.4 times cheaper than in December 2021 ($72.7) and 1.5 times cheaper than the average in 2022 ($76.7).

However, according to Alexander Isakov, chief economist at Bloomberg Economics for Russia, the budget revenue for the year was close to the September forecasts of the Ministry of Finance. On the other hand, the expenditure part rose significantly, by RUB2.1 trillion, and RUB1.3 trillion of this addition fell on “other expenses”, behind which the articles “national security” and “national defence” are hidden.

The first month of the European embargo on Russian oil has not yet been marked by an increase in world prices: a barrel of Brent now costs the same $80 as in early December. At the same time, Russian oil continues to get cheaper: on January 6 a barrel of Urals in the port of Primorsk in the Leningrad Region was sold at $38 – half the price of a barrel of Brent on the same day. In December, the Urals discount to Brent remained at the level of 30-35% – this was already an unprecedented figure, but it did not reach 50%.

The budget for 2023 was drawn up with the same deficit as in 2022, a deficit of 2% of GDP and an average annual price of Urals of $70.1 per barrel.

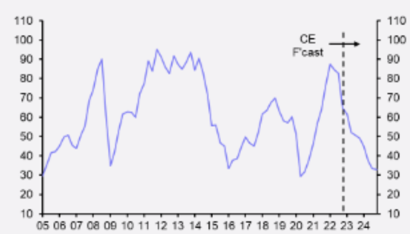
The level of budget problems will depend not only on the price of oil, but also on the volume of production. The Ministry of Finance included several scenarios in its forecast for 2023: with a price of $50 for Urals that has already arrived in December, and a decrease in production to a very possible 9mn bpd from a peak of 11mn bpd pre-war, this means oil and gas revenues for 2023 would amount to RUB6 trillion, RUB2 trillion below the plan and twice as much as the planned deficit for the 2023 budget.

Taking into account the ongoing war in Ukraine, it will be difficult for the government to reduce spending in 2023, which means that it will have to increase the revenue side. In 2022, this was done, among other things, by withdrawing dividend income from hundreds of thousands of Gazprom shareholders. In 2023, the budget is also planned to be replenished by raising the tax burden for large companies.

**The price of Urals crude – Russia's main oil blend – fell to $55/bbl in December from $75/bbl in August and $100/bbl in March.** Russia needs the cost of oil to be around $110 per barrel to balance the budget. This has reduced a key source of income for Russia's economy but there is often a lot of confusion about whether to focus on the impact of this on the budget or current account positions.

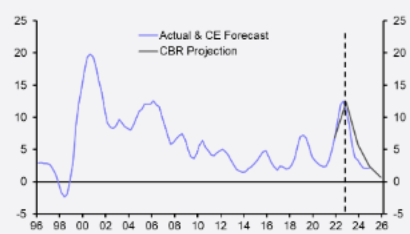
In December the Russian budget was still in surplus (but only due to massive one-off tax payments by Gazprom) and is expected to run a 2%-3% deficit in 2023. The current account was in a massive surplus of $270bn, although that could be reduced to some $100bn in 2023, depending on the efficacy of oil sanctions. Nevertheless, even $100bn is still close to pre-war all-time highs. However, the CBR projects a surplus of just $15bn in 2025, equivalent to 0.8% of GDP and the smallest since 1998.

Chart 5: Russia Energy Exports ($bn)




Sources: Refinitiv, CBR, FinMin, CEIC, Capital Economics

Chart 6: Russia Current Account (% of GDP)




Sources: Refinitiv, CBR, FinMin, CEIC, Capital Economics

"The distinction between the two is important. We estimate that Russia needs an oil price of about $110/bbl to balance the budget, but an oil price as low as $25/bbl to balance the current account. This gap reflects the fact that while higher government expenditure and the strong ruble have pushed the budget into a deficit (of 1% of GDP), depressed imports due to sanctions and high oil and gas prices have generated a massive private sector surplus and boosted the current account balance (to +13% of GDP)," says Oxford Economics.

"The budget will clearly stay in a large deficit with low oil prices, but the budget on its own doesn't tell us the whole story of Russia's ability to withstand low oil prices or sanctions, in part because a deficit can be funded domestically. This is exactly what Russia is doing. The government is financing the deficit by running down assets in the National Wealth Fund (NWF) – a fund where excess oil and gas tax revenues have been stored in recent years. More recently, the government has returned to the bond market and issued RUB1.5 trillion ($2.5bn) of OFZ bonds (ruble-denominated debt) since October, a record amount for two months. These two channels will be the main sources of financing over the next three years," Oxford Economics adds.

The NWF can realistically only be drawn down for two more years before it runs out. The government is having to issue a large share of floating-rate bonds to satisfy demand from banks, which exposes itself to more interest rate risk. And there is a concern more broadly that large debt issuance crowds out credit to the private sector.

**With Russia 1%-2% of revenues due to lower oil prices (and the oil cap) set at $60 in December, what are other sources of revenues** of the Federal budget? The most important revenues are VAT, profit taxes and excises.

| Federal budget | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|
| **Revenues (total)** | 25,286 | 27,693 | 26,130 | 27,240 | 27,979 |
| % of GDP | 19 | 19 | 17 | 17 | 16 |
| **Oil and gas revenues** | 9,057 | 11,666 | 8,939 | 8,656 | 8,489 |
| % of GDP | 6 | 8 | 6 | 5 | 5 |
| **VAT** | 9,202 | 9,424 | 10,417 | 11,208 | 12,048 |
| % of GDP | 7 | 6 | 7 | 7 | 7 |
| Domestic | 5,479 | 6,265 | 6,968 | 7,460 | 8,076 |
| On imports | 3,723 | 3,159 | 3,449 | 3,748 | 3,973 |
| **Excises** | 1,146 | 1,200 | 1,246 | 1,232 | 1,297 |
| % of GDP | 0.9 | 0.8 | 0.8 | 0.8 | 0.8 |
| **Profit taxes** | 1,552 | 1,564 | 1,633 | 1,823 | 1,969 |
| % of GDP | 1.2 | 1.1 | 1.1 | 1.1 | 1.2 |
| **SOE dividends** | 550 | 850 | 544 | 845 | 824 |
| % of GDP | 0.4 | 0.6 | 0.4 | 0.5 | 0.5 |
| **Other (incl import taxes)** | 3,780 | 2,989 | 3,351 | 3,476 | 3,353 |
| % of GDP | 4 | 2 | 2 | 2 | 2 |

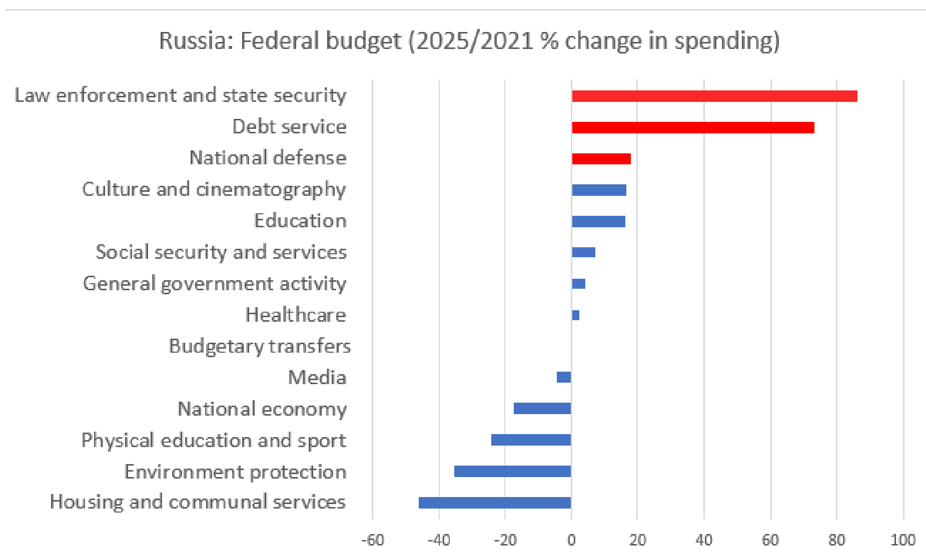
The MinFin lacked creativity forecasting taxes as a constant to GDP. VAT is Russia's second most important tax after oil and gas; it depends on domestic consumption and imports. Profit taxes depend on the domestic economy and dividends, with Gazprom being the largest payer,

How is Russia preparing to square the circle and live with lower oil and gas revenues (with or without the cap as their assumed price goes down to $65 by

2025)? As Russia has done before, with cuts in spending.

| Federal budget | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|
| **Revenues** | 25,286 | 27,693 | 26,130 | 27,240 | 27,979 |
| % of GDP | 19 | 19 | 17 | 17 | 16 |
| ***Oil and gas revenues*** | 9,057 | 11,666 | 8,939 | 8,656 | 8,489 |
| % of GDP | 6 | 10 | 10 | 8 | 6 |
| **Expenditure** | 24,762 | 29,006 | 29,056 | 29,433 | 29,244 |
| % of GDP | 19 | 20 | 19 | 18 | 17 |
| **Deficit (budget)** | 524 | -1,313 | -2,925 | -2,193 | -1,264 |
| % of GDP | 0.4 | -0.9 | -2.0 | -1.3 | -0.7 |
| **Non-oil/gas deficit** | -8,532 | -12,979 | -11,864 | -10,849 | -9,753 |
| % of GDP | 6.5 | 8.9 | 7.9 | 6.8 | 5.7 |

What are the spending priorities of the Russian government? Who needs housing, environment or sport when one can double down on state security against its citizens.



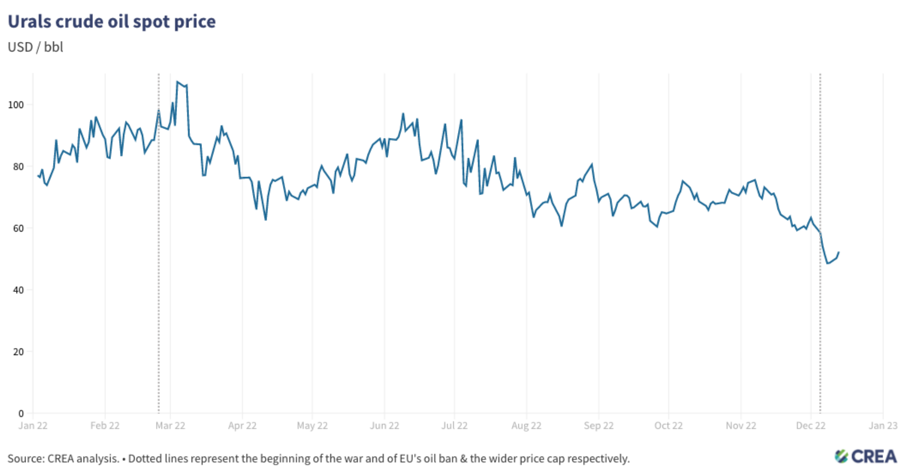

Estimate of changes in revenues vs oil prices.
X axis: Oil output in mbpd.
Y axis: Urals in USD.
Blue box: Russia's planned revenue 2023.
Green box: Today's situation.
Red box: Possibly after EU oil embargo (assumption: no Urals price change).
--> Compared to the budget plan for 2023, revenue could shrink by 2.5 trillion.

**Таблица 3.1.1. Нефтегазовые доходы федерального бюджета*: сценарный анализ**

*трлн рублей*

| Юралс, $/барр | добыча нефти, мбс | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 7,0 | 7,5 | 8,0 | 8,5 | 9,0 | 9,5 | 10,0 | 10,5 | 11,0 |
| 30 | 2,9 | 3,1 | 3,3 | 3,6 | 3,8 | 4,0 | 4,2 | 4,4 | 4,6 |
| 35 | 3,2 | 3,5 | 3,8 | 4,1 | 4,3 | 4,6 | 4,9 | 5,1 | 5,3 |
| 40 | 3,5 | 3,9 | 4,2 | 4,6 | 4,9 | 5,2 | 5,5 | 5,8 | 6,1 |
| 45 | 3,9 | 4,3 | 4,7 | 5,1 | 5,4 | 5,8 | 6,2 | 6,5 | 6,8 |
| 50 | 4,2 | 4,7 | 5,1 | 5,5 | 6,0 | 6,4 | 6,8 | 7,2 | 7,5 |
| 55 | 4,5 | 5,0 | 5,5 | 6,0 | 6,4 | 6,9 | 7,4 | 7,8 | 8,2 |
| 60 | 4,8 | 5,3 | 5,9 | 6,4 | 6,9 | 7,4 | 7,9 | 8,3 | 8,8 |
| 65 | 5,0 | 5,6 | 6,2 | 6,8 | 7,3 | 7,8 | 8,3 | 8,8 | 9,3 |
| 70 | 5,3 | 5,9 | 6,6 | 7,2 | 7,8 | 8,3 | 8,9 | 9,4 | 9,9 |
| 75 | 5,6 | 6,3 | 6,9 | 7,6 | 8,2 | 8,8 | 9,4 | 9,9 | 10,4 |
| 80 | 5,8 | 6,6 | 7,3 | 8,0 | 8,6 | 9,2 | 9,8 | 10,4 | 11,0 |
| 85 | 6,1 | 6,9 | 7,6 | 8,4 | 9,0 | 9,7 | 10,3 | 10,9 | 11,5 |
| 90 | 6,4 | 7,2 | 8,0 | 8,7 | 9,4 | 10,1 | 10,8 | 11,4 | 12,0 |
| 95 | 6,7 | 7,5 | 8,3 | 9,1 | 9,8 | 10,5 | 11,2 | 11,9 | 12,5 |
| 100 | 6,9 | 7,8 | 8,6 | 9,5 | 10,2 | 10,9 | 11,6 | 12,3 | 12,9 |

** в условиях 2025 года; оценка равновесного курса рубля произведена с учетом операций в рамках бюджетного правила*




How much does one need to cut Russia's oil output for the budget to feel the pain? With oil at $50 and oil output declining by 20%, Russia would lose 3.8% of GDP in revenues. If the ruble deprecates to RUB150/$, it loses 2.2%.

**Change in fiscal revenues, in % 2021 GDP**

| 75 RUB/$ — Brent oil price, in $/bbl | Decline in oil export volume (2022 vs. 2021), in % 0% | 5% | 10% | 20% | 30% | 40% | 50% | 60% | 70% | 80% |
|---|---|---|---|---|---|---|---|---|---|---|
| 50 | -3.4 | -3.5 | -3.6 | -3.8 | | | | | | |
| 75 | -1.4 | -1.6 | -1.8 | -2.2 | -2.6 | | | | | |
| 100 | 0.6 | 0.3 | 0.0 | -0.6 | -1.2 | -1.8 | | | | |
| 125 | 2.6 | 2.2 | 1.8 | 1.0 | 0.2 | -0.6 | -1.4 | | | |
| 150 | | 4.1 | 3.6 | 2.6 | 1.6 | 0.6 | -0.4 | -1.4 | | |
| 175 | | | 5.4 | 4.2 | 3.0 | 1.8 | 0.6 | -0.6 | -1.8 | |
| 200 | | | | 5.8 | 4.4 | 3.0 | 1.6 | 0.2 | -1.2 | -2.6 |
| 225 | | | | | 5.8 | 4.2 | 2.6 | 1.0 | -0.6 | -2.2 |
| 250 | | | | | | 5.4 | 3.6 | 1.8 | 0.0 | -1.8 |

*Notes: Urals discount assumed to be $25/bbl.*

**Change in fiscal revenues, in % 2021 GDP**

| 150 RUB/$ — Brent oil price, in $/bbl | Decline in oil export volume (2022 vs. 2021), in % 0% | 5% | 10% | 20% | 30% | 40% | 50% | 60% | 70% | 80% |
|---|---|---|---|---|---|---|---|---|---|---|
| 50 | -1.4 | -1.6 | -1.8 | -2.2 | | | | | | |
| 75 | 2.6 | 2.2 | 1.8 | 1.0 | 0.2 | | | | | |
| 100 | 6.6 | 6.0 | 5.4 | 4.2 | 3.0 | 1.8 | | | | |
| 125 | 10.6 | 9.8 | 9.0 | 7.4 | 5.8 | 4.2 | 2.6 | | | |
| 150 | | 13.6 | 12.6 | 10.6 | 8.6 | 6.6 | 4.6 | 2.6 | | |
| 175 | | | 16.2 | 13.8 | 11.4 | 9.0 | 6.6 | 4.2 | 1.8 | |
| 200 | | | | 17.0 | 14.2 | 11.4 | 8.6 | 5.8 | 3.0 | 0.2 |
| 225 | | | | | 17.0 | 13.8 | 10.6 | 7.4 | 4.2 | 1.0 |
| 250 | | | | | | 16.2 | 12.6 | 9.0 | 5.4 | 1.8 |

*Notes: Urals discount assumed to be $25/bbl.*

**Change in fiscal revenues, in % 2021 GDP**

| 50 RUB/$ — Brent oil price, in $/bbl | Decline in oil export volume (2022 vs. 2021), in % 0% | 5% | 10% | 20% | 30% | 40% | 50% | 60% | 70% | 80% |
|---|---|---|---|---|---|---|---|---|---|---|
| 50 | -4.3 | -4.4 | -4.4 | -4.5 | | | | | | |
| 75 | -3.0 | -3.1 | -3.2 | -3.5 | -3.7 | | | | | |
| 100 | -1.7 | -1.8 | -2.0 | -2.4 | -2.8 | -3.1 | | | | |
| 125 | -0.3 | -0.6 | -0.8 | -1.3 | -1.8 | -2.3 | -2.9 | | | |
| 150 | | 0.7 | 0.4 | -0.3 | -0.9 | -1.5 | -2.2 | -2.8 | | |
| 175 | | | 1.6 | 0.8 | 0.0 | -0.7 | -1.5 | -2.3 | -3.1 | |
| 200 | | | | 1.9 | 1.0 | 0.1 | -0.9 | -1.8 | -2.7 | -3.6 |
| 225 | | | | | 1.9 | 0.9 | -0.2 | -1.2 | -2.3 | -3.3 |
| 250 | | | | | | 1.7 | 0.5 | -0.7 | -1.9 | -3.0 |

*Notes: Urals discount assumed to be $30/bbl.*

**The Russian Finance Ministry spent RUB300bn ($5bn) from the National Welfare Fund (NWF) in November to finance the budget deficit,** RBC business portal reported citing the ministry. FinMin sold euros, pounds sterling, and Japanese yen from the NWF held in the Central Bank of Russia (CBR) accounts to transfer RUB300bn to the federal budget.

In the same week, Finance Minister Anton Siluanov revised the budget deficit forecast for 2022 to about 2% of GDP, up from the previous September estimate of 0.9% of GDP, or RUB1.3 trillion.

But Siluanov reiterated that despite the wider deficit the MinFin will minimise NWF spending by focusing on OFZ bond issuance instead. Indeed, FinMin has a RUB1 trillion ceiling for tapping into the NWF fund, as per the previous decree by Prime Minister Mikhail Mishustin. But the ministry is unlikely to use all of it this year (RUB260bn spent in October and RUB300bn in November)

As of December 1, the volume of the NWF amounted to RUB11.4 trillion, or

8.5% of 2022 projected GDP, and the volume of the fund's liquid assets (funds in CBR accounts) amounted to RUB7.6 trillion (5.7% of GDP).

In the law on the 2023-2025 federal budget, the deficit in 2023 is projected at RUB2.9 trillion, or 2% of GDP, cut to RUB1.26 trillion, or 0.7% of GDP, by 2025.

To remind, the NWF is projected at 3.7% of GDP in 2024, the lowest value for the fund since 3.1% of GDP in 2004, when the predecessor of NWF, the Stabilisation fund, was established. In nominal terms, the NWF will fall to its lowest level since 2018, the year of transformation of the fund to its current format.

As followed by *bne IntelliNews*, the NWF was merged with the Reserve Fund in 2018 and is regulated by the so-called “budget rule” that caps federal budget spendings and thus the fund allocations at cut-off oil price.

The budget rule was first compromised during the outbreak of COVID-19 pandemic and suspended in 2022 amid the Western sanctions for Russia’s military invasion of Ukraine. While FinMin is redrafting the rule, there will be no transfers to the NWF until the end of 2023.

**President Putin signed the law on the federal budget for 2023** and the planned period of 2024-2025, with the document posted on the official web portal of legal information.

According to the law, Russia’s budget expenditures will total RUB29 trillion ($465.7bn) in 2023, RUB29.4 trillion ($472.1bn) in 2024, and RUB29.2 trillion ($468.9bn) in 2025. Revenues will stand at RUB26.1 trillion ($419.1bn) in 2023, RUB27.2 trillion ($436.8bn) in 2024, and RUB27.9 trillion ($448bn) in 2025.

The deficit in 2023 is projected at 2% of GDP (or around RUB3 trillion ($49.3bn)), with mainly borrowings planned to be used to cover it. Meanwhile, it is expected that the budget deficit will gradually go down to 0.7% in 2025.

The draft budget is based on a baseline outlook on Russia’s socio-economic development for 2023-2025, which suggests a gradual decline of the Urals oil price from $80 per barrel in 2022 to $65 in 2025, the moderate weakening of the ruble’s exchange rate from RUB68.1 to RUB72.2 per $1 and the return to the targeted inflation level of 4% by the end of 2024 from 12.4% in 2022.

The baseline scenario assumes that the Russian economy will shift to recovery growth in early 2023, whereas by the end of 2024 the majority of the main indicators, including GDP, industrial production and fixed investment, will surpass the pre-crisis level in comparable prices.

**The oil price cap of $60 introduced on December 5 is not expected to have much of an impact on the budget deficit in 2023. The deficit in 2023 is anticipated to increase from earlier estimates of 2% to GDP to 3%, according to IIF.** With an oil price cap of $60 the 2023 deficit is predicted to widen to ~3% of GDP, up from the previously forecast of 2%. Russia has plenty of resources to cover this hole.

The oil price cap also means that Russia's debt-to-GDP ratio will be 17%. The Ministry of Finance (MinFin) has already said that it will increase the amount it borrows by issuing some RUB2 trillion of OFZ, which will become the main funding tool for the budget.

These can be bought by Russian banks that hold about 1% of GDP in cash. The National Welfare Fund (NWF) will also be tapped to fund the deficit; it currently holds about 9% of GDP in funds.

And as oil exports are anticipated to continue more or less unimpeded, Russia is expected to continue to run a very substantial current account surplus in 2023 that will also provide funds.

| Federal budget | 2021 | 2022 | 2023 | 2024 | 2025 |
|---|---|---|---|---|---|
| **Revenues** | 25,286 | 27,693 | 26,130 | 27,240 | 27,979 |
| % of GDP | 19 | 19 | 17 | 17 | 16 |
| ***Oil and gas revenues*** | 9,057 | 11,666 | 8,939 | 8,656 | 8,489 |
| % of GDP | 6 | 10 | 10 | 8 | 6 |
| **Expenditure** | 24,762 | 29,006 | 29,056 | 29,433 | 29,244 |
| % of GDP | 19 | 20 | 19 | 18 | 17 |
| **Deficit (budget)** | 524 | -1,313 | -2,925 | -2,193 | -1,264 |
| % of GDP | 0.4 | -0.9 | -2.0 | -1.3 | -0.7 |
| **Non-oil/gas deficit** | -8,532 | -12,979 | -11,864 | -10,849 | -9,753 |
| % of GDP | 6.5 | 8.9 | 7.9 | 6.8 | 5.7 |
| **Deficit (oil price cap)** | | | -4,464 | | |
| % of GDP | | | -3.1 | | |

**Bruegel estimates that a RUB10 shift in the dollar exchange rate triggers a 1.2% of GDP change in revenues from crude oil, petroleum products and natural gas** through its effect on extraction taxes and export duties. Bruegel also found that the effect of a $10 per barrel move in the price of crude oil and petroleum products amounts to roughly 0.8% of Russian GDP, and a $10 per MWh of natural gas amounts to about 0.5% of GDP.

In 2023 the MinFin has several options to fund the budget.

Expenditure cuts are likely should revenues continue to fall short, and in October 2022 the MinFin already ordered 10% cuts across the board of non-essential items like pensions. In addition, the finance ministry should, if needed, be able to considerably increase net issuance of domestic debt as domestic banks have plenty of ruble liquidity.

However, expenditure cuts would have significant medium- and long-term consequences for the economy and the welfare of the Russian people. But Russia succeeded in building up fiscal buffers through significant fiscal consolidation after 2014, when sanctions were first imposed following the annexation of Crimea. In this respect, the Fortress Russia strategy is working as intended.

## • Debt and gross international reserves

**The Finance Ministry returned to the Russian capital market to borrow heavily in late 2022**, after taking a break for seven months after the war started, and destabilised the OFZ domestic bond market. However, it didn't borrow significantly more than planned.

~RUB2.2 trillion new net debt
~RUB1.0 trillion expiring old debt
~RUB3.3 trillion bond issuance in total in 2022.

**The stock of Russian government's foreign debt has been quite small in recent years.** At the end of 2021, the debt stock stood at just $63bn (3.5% of GDP).

The value of Russian government Eurobonds owned by foreigners dropped substantially after Russia's illegal annexation of the Crimean peninsula in 2014, but recovered somewhat in the following years. In 2022, the value again started to decline.

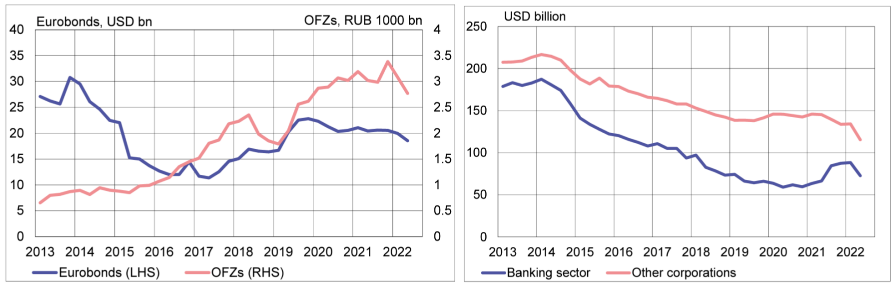
An even larger decline was recorded in the value of government domestic bonds (OFZs) owned by foreign investors. The long-term rising trend was abruptly reversed after the war started.

The movements in government debt markets are also dampened by restrictions on capital flows.

Foreign financing has been much more important for the Russian corporate sector. The stock of foreign debt (excluding the government and central bank) was $380bn (21.5% of GDP) as of end-2021. Of that, about 30% was denominated in rubles and largely related to direct investors (potentially of Russian origin, as discussed above), whereas 70% was denominated in foreign currencies, mainly US dollars.

The value of foreign debt denominated in foreign currencies has been on a downward trend since Russia's illegal annexation of Crimea in 2014. Even so, there was still another sharp drop in the value after Russia invaded Ukraine.

**Figure 5**. A) The value of the eurobond and domestic bond stock issued by the Russian government held by foreign investors. B) Stock of foreign debt of the Russian banking sector and other corporates denominated in foreign currencies.




Source: Central Bank of Russia.

**As the situation with funding the budget deteriorates in 2023 thanks to factors like the European oil embargo and the economic recession, the government is intending to fund the expected 2-3% of GDP deficit using the National Welfare Fund (NWF) and issuing more Russian Finance Ministry's OFZ treasury bills.**

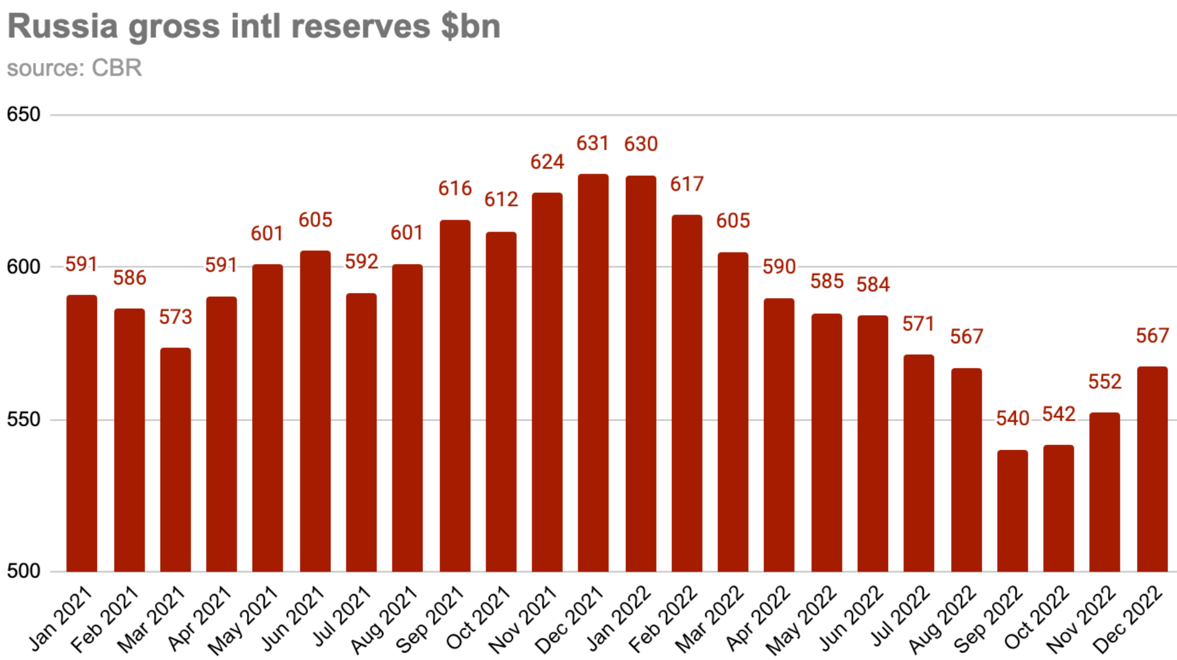
OFZ on the domestic markets are expected to rise from circa RUB2 trillion a year to RUB3,500 trillion in 2023.

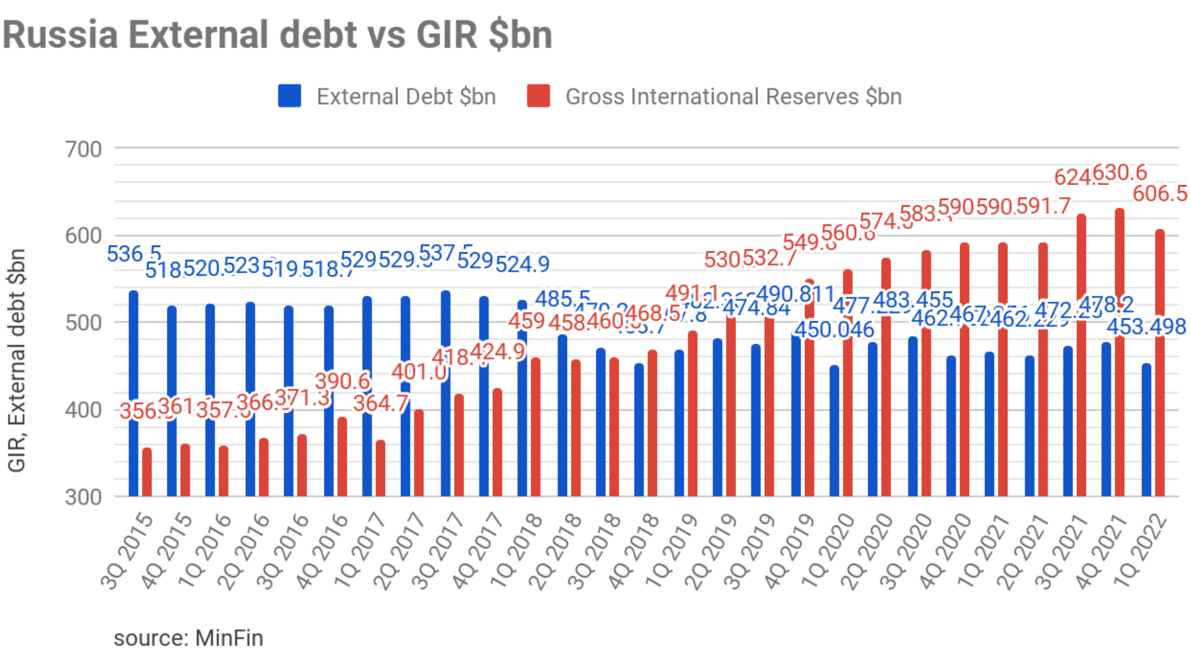
The transition to a fiscal rule in its updated version, according to a Ministry of Finance plan, involves a structurally higher level of federal budget expenditures relative to the previous version. OFZ placements will come as the main source to finance a budget deficit, says the CBR.

The Ministry of Finance, back in the domestic debt market after a half-year break, ramped up placements in November mainly through floating-coupon securities (OFZ-PK). Their core buyers were banks that use OFZ-PK securities to improve liquidity indicators, as well as to reduce the sensitivity of their income to money market rates (interest risk).

The banks boast massive technical capabilities to purchase OFZ-PK securities, according to the CBR. Yet the amount of financing available through this channel is limited. A substantial budget deficit adds to demand in the economy, thereby increasing pro-inflation risks. This factor should be addressed in monetary policy.

**Russia has very little external debt, which amounted to around 15% of GDP in 2022 and is expected to rise to around 17% in 2023.** Russia's gross international reserves (GIR) are more than enough to cover the entire external and public debt dollar for dollar, even after the $300bn of frozen CBR funds is counted out.


Russia gross intl reserves $bn
source: CBR
650
600
550
500
591
586
573
591
601
605
592
601
616
612
624
631
630
617
605
590
585
584
571
567
540
542
552
567
Jan 2021
Feb 2021
Mar 2021
Apr 2021
May 2021
Jun 2021
Jul 2021
Aug 2021
Sep 2021
Oct 2021
Nov 2021
Dec 2021
Jan 2022
Feb 2022
Mar 2022
Apr 2022
May 2022
Jun 2022
Jul 2022
Aug 2022
Sep 2022
Oct 2022
Nov 2022
Dec 2022


Russia External debt vs GIR $bn
External Debt $bn
Gross International Reserves $bn
GIR, External debt $bn
700
600
500
400
300
3Q 2015
4Q 2015
1Q 2016
2Q 2016
3Q 2016
4Q 2016
1Q 2017
2Q 2017
3Q 2017
4Q 2017
1Q 2018
2Q 2018
3Q 2018
4Q 2018
1Q 2019
2Q 2019
3Q 2019
4Q 2019
1Q 2020
2Q 2020
3Q 2020
4Q 2020
1Q 2021
2Q 2021
3Q 2021
4Q 2021
1Q 2022
source: MinFin

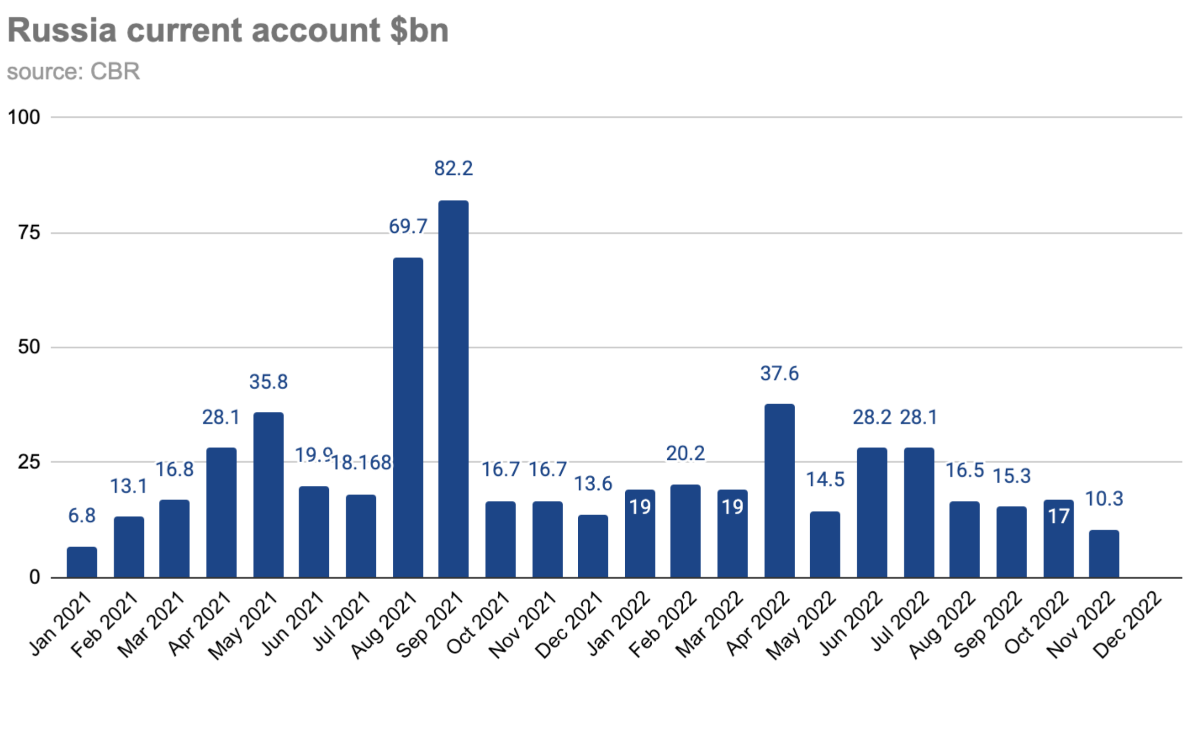
## • Current account

**According to preliminary data from the CBR, Russia posted a current account surplus of $10.3bn in November**, down from $17.7bn in October and $16.5bn last November, but much higher than the surpluses seen in November of 2019 and 2020.

This brought the current account surplus over 11m22 to $225.7bn. The narrowing of the current account surplus in November was attributable to the goods and services surplus, which shrank to $12.7bn from $19.3bn in October due to lower oil and gas exports and a recovery in imports. This put the goods and services surplus over 11m22 at $269.8bn. With all that being said, the current account data is subject to revision.

The 11m22 data was generally in line with our expectations. We anticipate a current account surplus of around $10bn in December as well. This would bring the surplus over the full year to $235bn. Next year, we expect the current account surplus to shrink to $120bn due to higher imports and lower exports.

**There is little clarity on where the current account will be in 2023 but analysts are fairly sure it will be in surplus again and by at least $100bn.**



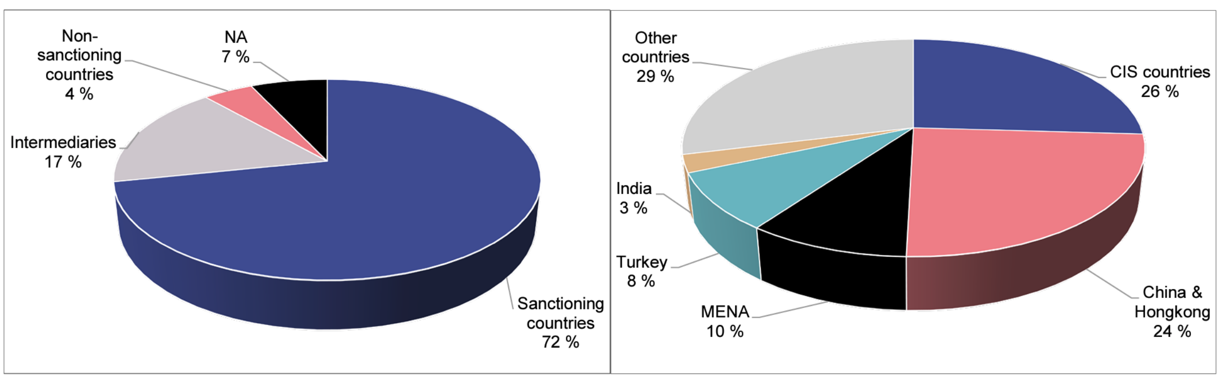
## • FDI

**Sanctioning countries accounted for over 70% of Russia's inward FDI stock ($520bn) as of the end of 2021.**

Countries typically serving as FDI intermediaries (e.g. Bahamas and Bermuda) accounted for 17% of Russian inward FDI. A large part of FDI from these intermediary countries is actually just Russian capital that is roundtripping through these countries for various reasons.

The share of non-sanctioning countries was only 4% in Russia's FDI stock or $60bn as of end-2021. Among non-sanctioning countries, the largest investors have been China and members of the Commonwealth of Independent States (CIS). Turkey and certain Middle Eastern countries also account for a substantial share of FDI from non-sanctioning countries

**Figure 2.** Breakdown of Russia's total inward FDI stock and FDI stock from non-sanctioning countries as of end-2021.




Source: Central Bank of Russia.

# 5.0 Real Economy

**Industrial production in Russia decreased 2.6% y/y in October of 2022,** following a 3.1% fall in the previous month and compared with market expectations of a 3.8% decline.

It was the seventh consecutive month of falls in industrial activity, as output went down for mining (-2.7% vs -1.8% in September); electricity, steam and air conditioning (-2.4% vs -1.5%); manufacturing (-2.4% vs -4%) and water supply, wastewater disposal, and the collection and organisation of waste (-7.4% vs -7.5%). On a monthly basis, industrial production jumped 5.3%, following a 0.5% increase in September, according to RosStat.

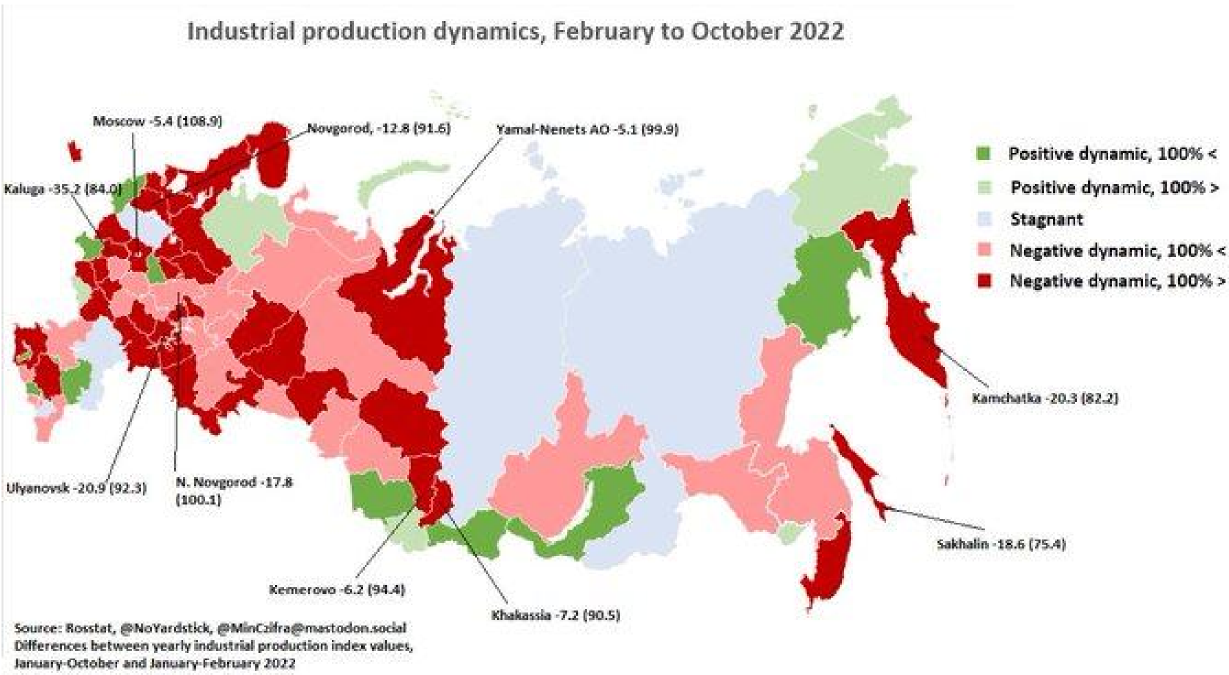
There are continued problems in the timber producing regions of the Northwest, in regions with an automotive industry and machine building, coal mining, metallurgy (most of these face a loss of export markets and transit bottlenecks) and now also in gas producing regions.

Siberia and the Far East are still doing relatively OK, with some notable exceptions. But due to a lack of infrastructure and very concentrated investments into a handful of big projects, there's a limit to how much these regions can heat up as others cool down.

Importantly, problems with industries will not break regional finances just yet. With some exceptions, most regions are on track to meet their plans for corporate income tax receipts in 2022 (according to official numbers).

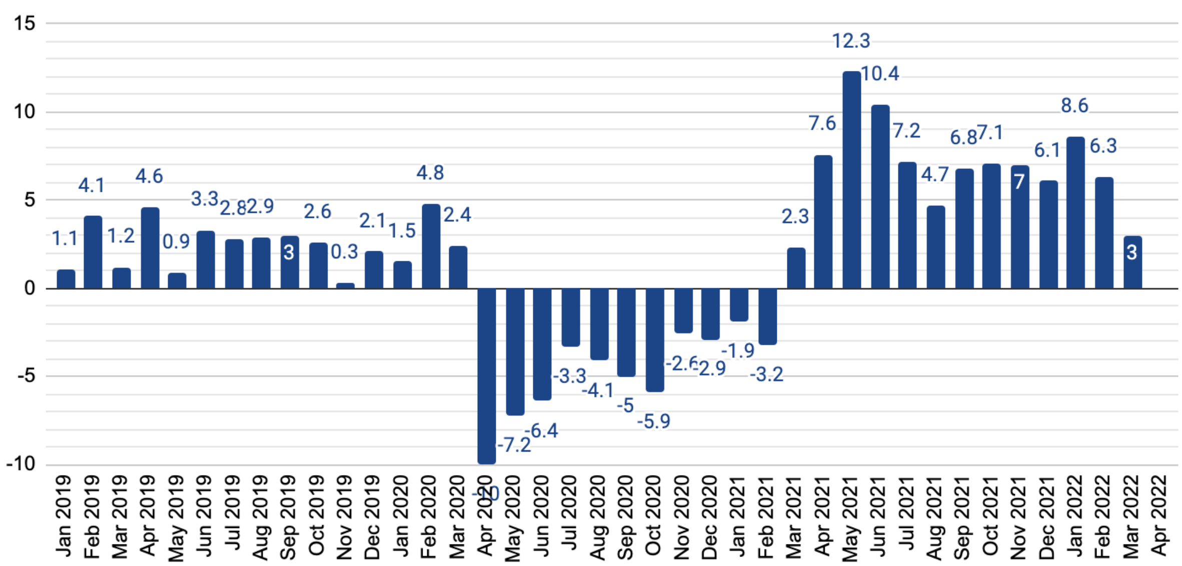
This is, however, to a considerable extent due to high receipts in H1. At the end of July, the picture was much rosier still. Then nine regions had collected less than 50% of planned corporate income tax, now 17 have collected less than 80%.

Even if the situation still worsens before the end of the year, the federal budget will likely simply increase transfers for now. But these problems will continue and receipts – including personal income tax, which has been fairly stable so far – will drop further in H1 2023.




**Russia industrial production y/y**

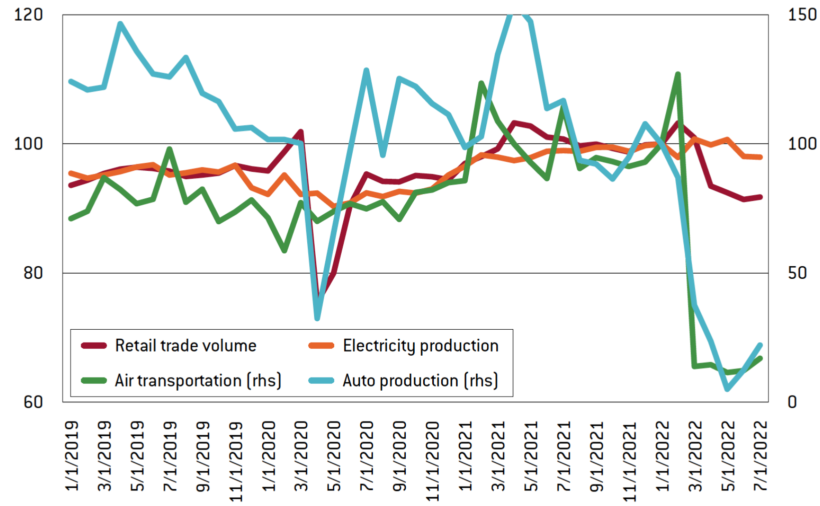
source: Rosstat




# • Industrial production and PMI

**Export controls and self-sanctioning by international suppliers have seriously impeded the Russian economy's ability to acquire components for manufacturing activities.** While Russia's economy is less reliant on imports than most other large, advanced economies and emerging markets, some sectors are highly exposed, especially the manufacturing of transportation equipment, chemicals, food products and IT services.

**Figure 17: Export controls have had a big impact on activity**




Source: Rosstat.

Releases of high-frequency data for the second and third quarter 2022 allow an initial assessment of the impact of sanctions to be made, and to distinguish the impacts on different sectors.

The withdrawal of foreign car manufacturers and the shortage of inputs has hit passenger car production extremely hard, with a 95% decline in May 2022 compared to May 2021.

Air transportation has also collapsed following the cancellation of aircraft leases and maintenance contracts, and the closure of several countries' airspaces to Russian planes.

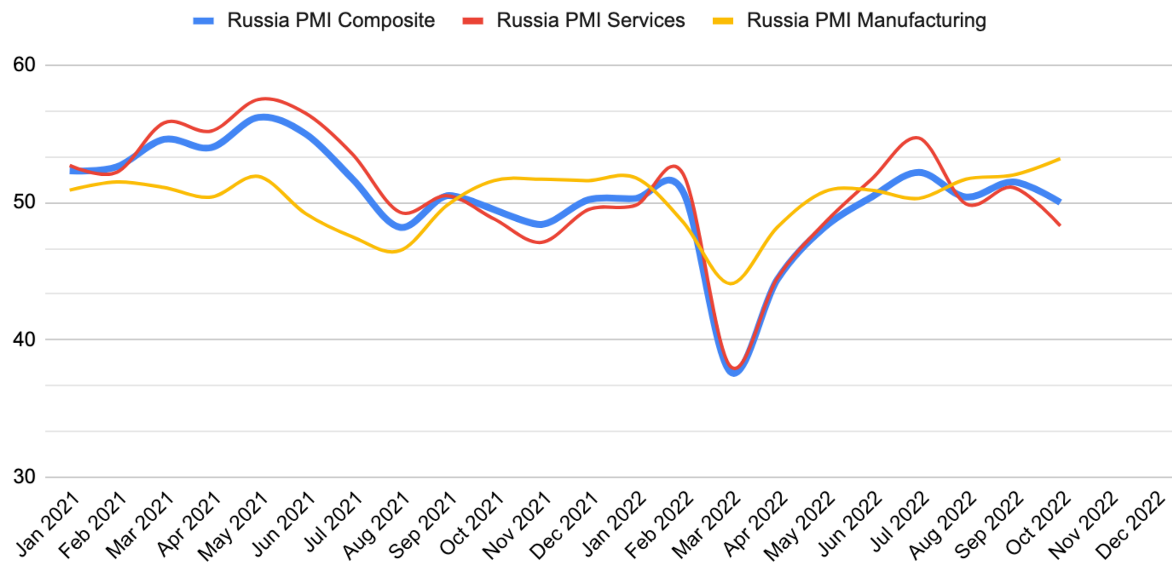
Crude oil production has rebounded after a drop in April, and overall industrial production appears relatively strong, but natural gas production has fallen sharply, especially in July (at -19% relative to January 2022).

Altogether, RosStat's monthly output tracking shows six consecutive months of decline since January, totalling 8.1%, with April most negative at -4.6%. Assuming output remained at the same levels in the last months of 2022, the full-year decline would amount to only 2.3%.

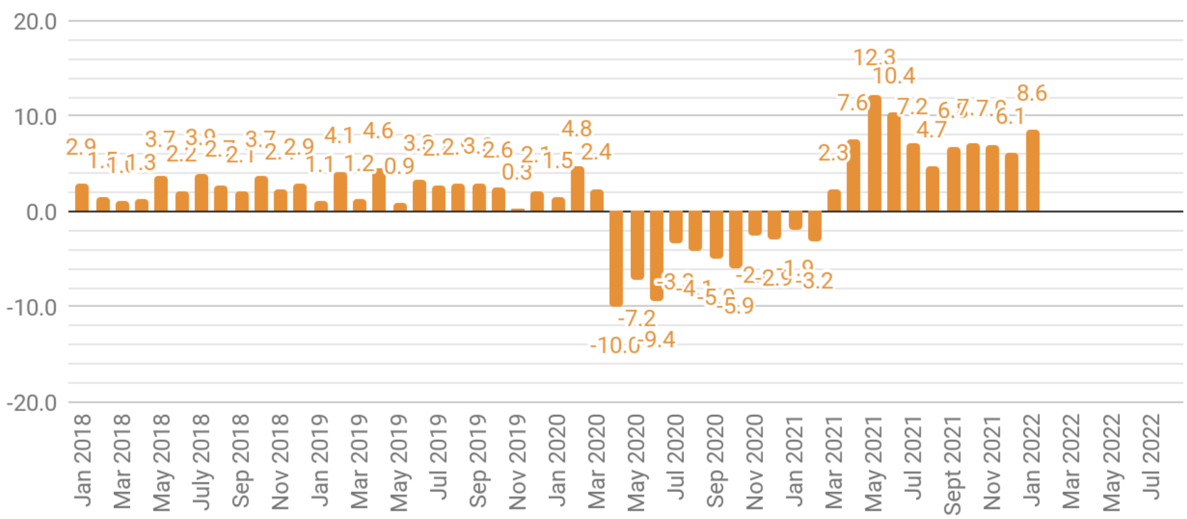
Bruegel says this indicator does not include all economic activity as it misses, most importantly, parts of the services sector, and may understate the depth of the recession.

## Russia PMI

source: S&P Global

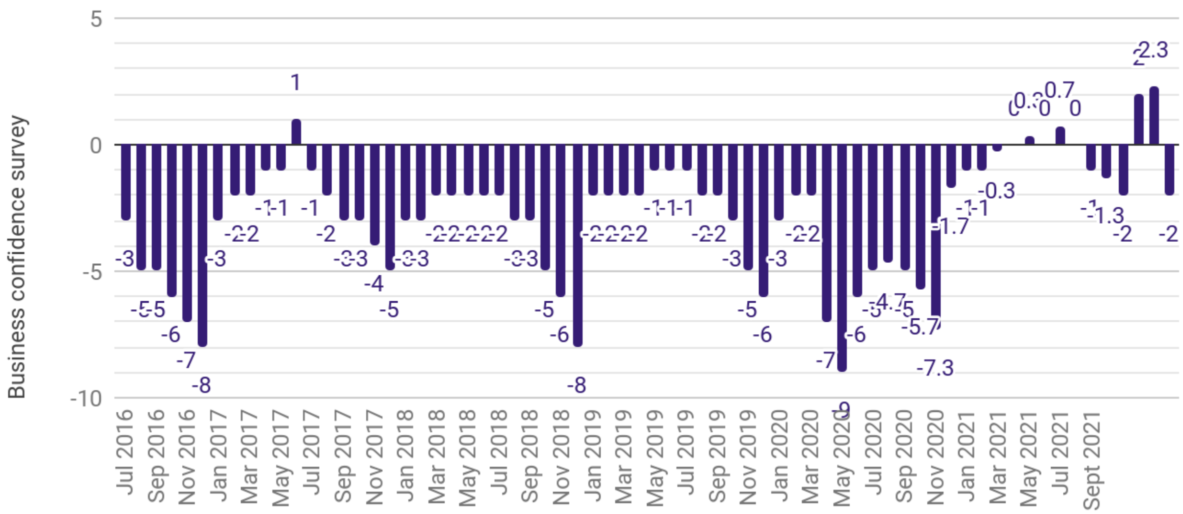



## Russia industrial production y/y %




source: Rosstat

## Russia business confidence survey




source: Rosstat

# • Energy

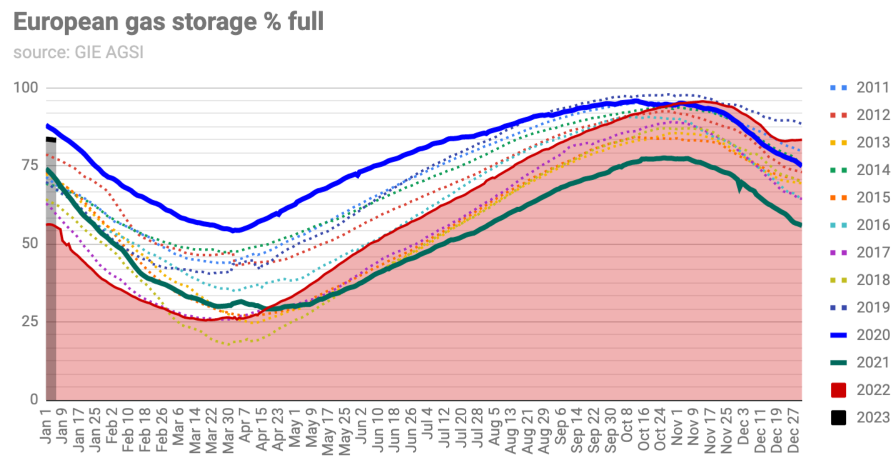
### Gas:

**Russia's Gazprom gas giant produced 412.6bn cubic metres of gas in 2022,** the company's CEO Alexey Miller said. "As for gas output, it stood at 412.6 bcm in 2022. Gazprom exported 100.9 bcm of gas to countries outside the former Soviet Union," the company's statement quoted Miller as saying. Gas production fell by about 20% compared to 2021 and exports dropped by 45.5%. According to the latest data, 243 bcm of gas were supplied to domestic consumers. "Our priority goal is to ensure gas supplies to Russian customers. We confidently achieved it, as always," Miller emphasised.

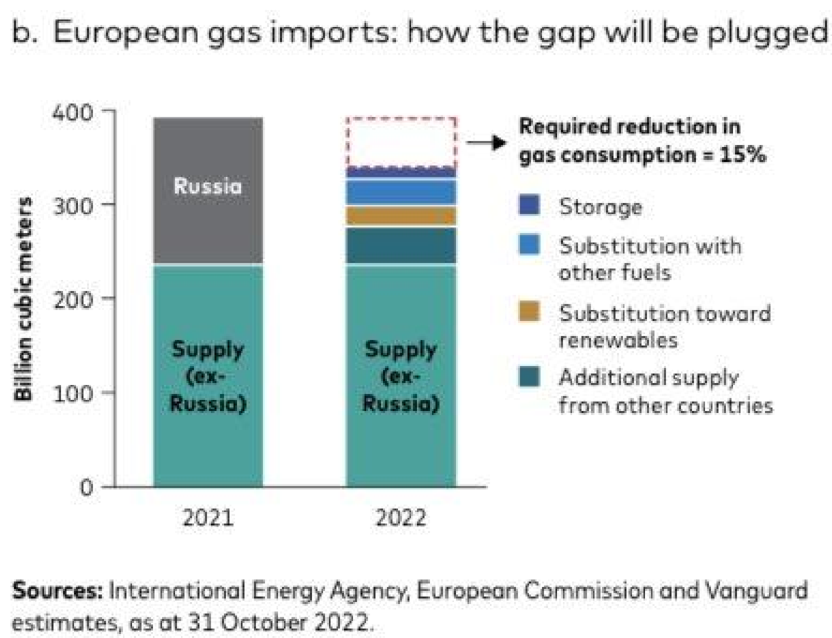
**Gazprom's exports to the EU were 100.9 bcm in 2022.** This represents a decrease of 45% compared to 185.1 bcm in 2021 to Europe, of which 155 bcm was to the EU and the rest to non-EU countries. The halving of supplies to the EU that will buy more LNG and gas from North Africa and Norway is hurting Russia's geopolitical ambitions.

**With the Nord Stream pipelines out of action Russian deliveries of gas to Europe are likely to fall to around 50 bcm in 2023** – almost exclusively via Ukraine (20 bcm) and Turkey (32 bcm).

It remains an open question if Europe will receive sufficient gas to refill its storage tanks in the coming winter, which remain fuller than at any time in the last decade. The IEA is forecasting a 30 bcm gas deficit in Europe in 2023, part of which can be provided by LNG, as well as using alternative sources like coal, nuclear and building more renewable resources. The energy outlook for 2023 will once again remain heavily dependent on the weather.




Gas storage in Europe % full




**The EU has no plans to restrict prices for Russian gas any time soon,** a source in Brussels told PRIME on December 16. "The European Commission has no intent to insist on this decision any time soon, these negotiations are only testing the ground," the source said. According to the official, the EU also has no plans to embargo Russian gas imports. "Concerning an embargo on imports of Russian gas in the same format as an oil embargo that the EU introduced in the framework of the measures against Russia, this is not on the agenda," the source said. Late on December 15, the EU issued a statement saying it needed to spur up negotiations with reliable partners to sign long-term gas agreements, taking into account the prospects of the 2023-2024 winter.

**Gas production in Russia in January-November 2022 decreased by 11.6% compared to the same period last year and amounted to 612.9 bcm**.

The main contribution to the overall dynamics was made by the decline in production at Gazprom. The largest independent gas producers – Rosneft and Novatek – showed an increase in production.

According to expert forecasts, if exports continue to decline, gas production in Russia by the end of 2022 may decrease by about 11% and amount to 677 bcm.

**According to preliminary data, natural gas production by Gazprom dropped by 19.6% y/y to 394.1 bcm YTD in December.** Gas exports to non-CIS countries fell by 45.1% or by 80.2 bcm over the last 11.5 months, the Russian gas holding said. The average daily export of Gazprom gained 30% in December against November to 173.3 mcm. Gas demand on the domestic Russian market contracted by 5.2% or by 12.5 bcm.

**According to the results of 2022, Gazprom Mezhregiongaz plans to supply 253 bcm of gas to the Russian market**, Deputy CEO of Gazprom Mezhregiongaz Yury Pakhomovsky said on December 15. The company noted a growing trend in gas consumption. Thus the most noticeable growth in gas consumption this year will be because of population – an increase of 4.3 bcm compared to the plan. The company forecasts an increase in gas supplies to the Russian market by 2025 of at least 15 bcm from the resources of Gazprom, and by 2030 the growth may reach 50 bcm, Pakhomovsky said.

**Gas exports from Russia dropped sharply after the start of the war in Ukraine.** According to Vedomosti calculations based on data from the European Network of Gas Transmission System Operators (ENTSOG), at the end of November 2022, Russia supplied the European Union with, on average, 76-77 mcm of gas per day against 368-377 mcm at the end of November 2021. The main route for the supply of Russian pipeline gas to the EU is now transit through the gas transmission system of Ukraine (on average 42-43 mcm per day). The rest is exported to the EU via TurkStream. Gas supplies via Nord Stream were completely stopped at the end of August, exports via the Yamal-Europe pipeline have not actually been pumped through since the end of 2021, and Nord Stream 2, completed last autumn, has not been launched.

**China may soon surpass the entire European Union in terms of gas consumption if the decline in demand in Europe continues**, deputy department head at Gazprom Kirill Polous said on December 15. "China's gas demand has grown at an astonishing rate of more than 13% per year since the turn of the century. During this time, China's gas consumption increased by over 350 bcm. If European gas demand continues to diminish, it is extremely likely that, in the near future, China's yearly gas consumption will exceed that of the EU," he said, adding that by the end of 2022, China's gas consumption is projected to be 375 bcm. By 2040, gas consumption in China may increase to 700 bcm, China's import potential will more than double up to 330 bcm, he added.

Russia's gas producers other than Gazprom increased production. Gas production by **Rosneft** (including shares in joint ventures) in January-November rose by 15.2% to 61.8 bcm. Novatek's output grew by 2.1% to 76.3 bcm, Gazprom Neft's by 17.1% to 46.4 bcm. Tatneft's production increased by 8.5% to 835.8 mcm.

**Of the major independent gas producers**, production was reduced by Lukoil (by 0.8% to 18.7 bcm), Surgutneftegaz (by 8.9% to 7.6 bcm) and the Independent Oil and Gas Company (by 3.1% to 6.2 bcm). Gas production under production-sharing agreements (Sakhalin-1, Sakhalin-2 and Kharyaginskoye PSA projects) decreased by 13% to 22.7 bcm, the interlocutors of *Vedomosti* reported.

According to *Vedomosti's* calculations, in general, the production of all independent producers for 11 months in aggregate reached 236 bcm, an increase of 4.6% y/y.

**In 2023, if the current geopolitical situation continues, according to Alfa-Bank, the decline in exports will persist – it may fall by more than 28%,** or by about 28 bcm. This will mean that the decline in gas production in Russia next year will be at least 4%. "However, in the event of a further slowdown in the Russian economy and a possible decrease in the production of gas chemical products, this estimate may turn out to be too optimistic, and the real decline in production in 2023 will be up to 10%," the expert concludes.

## Oil:

**In 2022, Russia increased oil production by 2%, to 535mn tonnes,** and in the top four producers, only the sanctioned Rosneft reduced production, writes *Kommersant*. Exports to non-CIS countries via pipelines and the sea as a whole expanded by almost 19% during the year, to 207mn tonnes.

But it seems that this is the last year of growth. Under the conditions of the

European embargo and the price ceiling, industry experts predict a decline in production in January-February 2023, which will be exacerbated by a drop in demand from Russian refineries.

The fact is that reorienting the sale of petroleum products (the EU embargo on them comes into effect on February 5) is much more difficult than oil. Therefore in February, the demand for oil from Russian refineries may decrease by 2.8–3.2mn tonnes compared to January, and production by 2.5–3mn tonnes. In December, oil exports from Russia by sea decreased in any case by about 20%.

Meanwhile, Russian oil delivered from the Baltic ports is sold at a discount of 50% to Brent in January. Urals in Primorsk cost $37.80 per barrel in the first week of January, with Brent at $78.57.

Russia has become dependent on a tiny pool of buyers, mainly China and India, the agency explains. But even in these areas, Baltic oil is forced to compete with the Middle East, and the shortage of tankers and long delivery routes, which have lengthened from days to weeks or even months, can only be compensated for by a discount.

Domestic experts consider $40 per barrel as the level of budget catastrophe. Bloomberg does not exclude that Russia will soon go for a direct reduction in production.

**Russia increased oil exports in November to a maximum volume since April – by 270,000 bpd to 8.1mn bpd, according to the report of the IEA.**

At the same time, according to IEA estimates, Russia's export revenues decreased by $0.7bn and amounted to $15.8bn in November.

Oil exports remained virtually unchanged in the last months of 2022 and amounted to around 5mn bpd, despite a decline in oil supplies to the EU by 430,000 bpd to 1.1mn bpd. Deliveries to India reached a new high of 1.3mn bpd. Meanwhile, Russia increased exports of petroleum products, mainly diesel fuel, by 300,000 bpd to 1.1mn bpd.

The IEA also stated that in November 2022 Russia had increased oil output by 90,000 bpd, to 9.81mn bpd. In December, production may decrease by 400,000 bpd against the background of the entry into force of the EU embargo, and by April next year, by 1.8mn bpd from pre-February levels, the IEA believes.

At the same time, the total volume of production of liquid hydrocarbons in Russia reached 11.2mn bpd, which is only 200,000 bpd below the levels before February 2022, the report said.

**OPEC+ countries in November 2022 reduced oil production by 480,000 bpd instead of the planned 2mn bpd**, the IEA said in its December report. The real reduction in oil production by the alliance amounted to only a quarter of the planned volume. However, Russia was able to increase oil output (excluding gas condensate) by 90,000 bpd to 9.81mn bpd, but still produces 670,000 bpd less than the target. Meanwhile, Saudi Arabia reduced production by 420,000 bpd to 10.48mn bpd, having fully fulfilled its obligations under the OPEC+ deal.

At a meeting on October 5, the countries participating in the OPEC+ deal agreed to reduce output by 2mn bpd from November, and also extended the deal until the end of 2023. The countries' production volumes in August 2022 were taken as the basis for calculating the reduction in oil output.

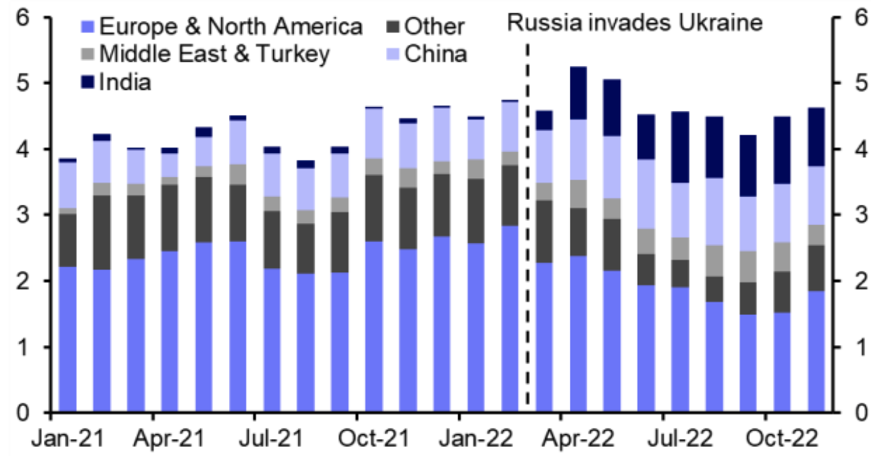
The next meeting of the OPEC+ monitoring committee will take place on February 1, 2023, and the general meeting of the alliance is scheduled for June 4, 2023.

**OPEC has maintained its forecast for the growth of world oil demand in 2022 at 2.5mn bpd to 99.6mn bpd,** the organisation said in a report in December.

The forecast for demand growth for 2023 was also kept at 2.2mn bpd, and the figure is expected to reach 101.8mn bpd.

**Export by sea and oil pipelines to non-CIS countries in November decreased by 4%, to 615,000 tonnes per day.** This was partly compensated by the growth of primary oil refining at Russian refineries (by 2%, to 785,000 tpd). There are no export restrictions on petroleum products, but only for now – they come into force on February 5.

## Chart 12: Russia Crude Oil Shipments (Mn Bpd)




### Power:

**The export of electricity from Russia to China has grown by 23% since the beginning of the year** to December, said Russian Energy Minister Nikolai Shulginov. In November in physical terms, the volume of supply, according to *Kommersant's* information, could reach a record figure of 4.2bn kWh. However, the Chinese direction still does not allow the Russian Federation to replace the EU market lost due to hostilities: this year, the total export of electricity may decrease by a third compared to the previous one.

Chairman of the board of directors of Inter RAO Igor Sechin said at the end of November that against the backdrop of heat and energy shortages, the company, at the request of the PRC, in January-October increased supplies to China by 33%, to about 4bn kWh.

Inter RAO buys energy from power plants in the Far East (mainly from RusHydro), and then resells it to China, paying extra for transmission services. The profitability of supplies to China was estimated at 30%, but the regulator limits the company's profit at 5% per year, with the rest of the revenue being distributed to market participants in the Far East. The technical capabilities of power transmission lines allow Russia to transmit to China up to 6-7bn kWh, according to Regina Lyanzberg from Kept. Delivery of 7bn kWh is possible only with an increase in the installed power capacity in the Far East, she notes.

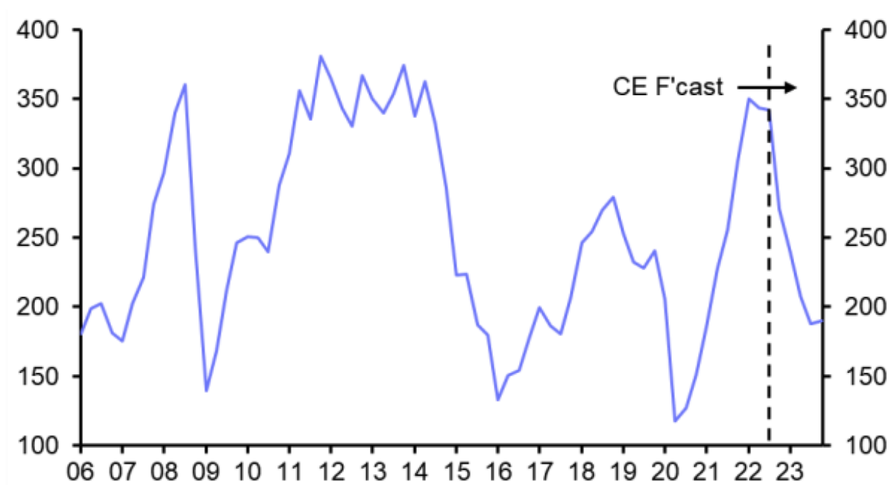
The largest and most profitable direction for Inter RAO has historically been Finland, Latvia and Lithuania, where 60% of exports went. However, in May, deliveries there stopped due to problems with the calculations. Russia managed to sell to the EU, according to *Kommersant's* information, about 4-5bn kWh against the backdrop of high prices.

Kazakhstan is still the main buyer: deliveries there, according to *Kommersant's* information, may amount to about 5bn kWh. Inter RAO refuted *Kommersant's* data on the level of deliveries to Kazakhstan, refusing to give actual figures.

The remaining export destinations for Inter RAO are unlikely to be able to replace closed deliveries to the EU. So in October, Andrey Logatkin, director of the Department of International Cooperation at RosSeti, said that electricity exports from Russia by the end of 2022 could fall to 13.5bn kWh, which is 38% lower than last year's figures.

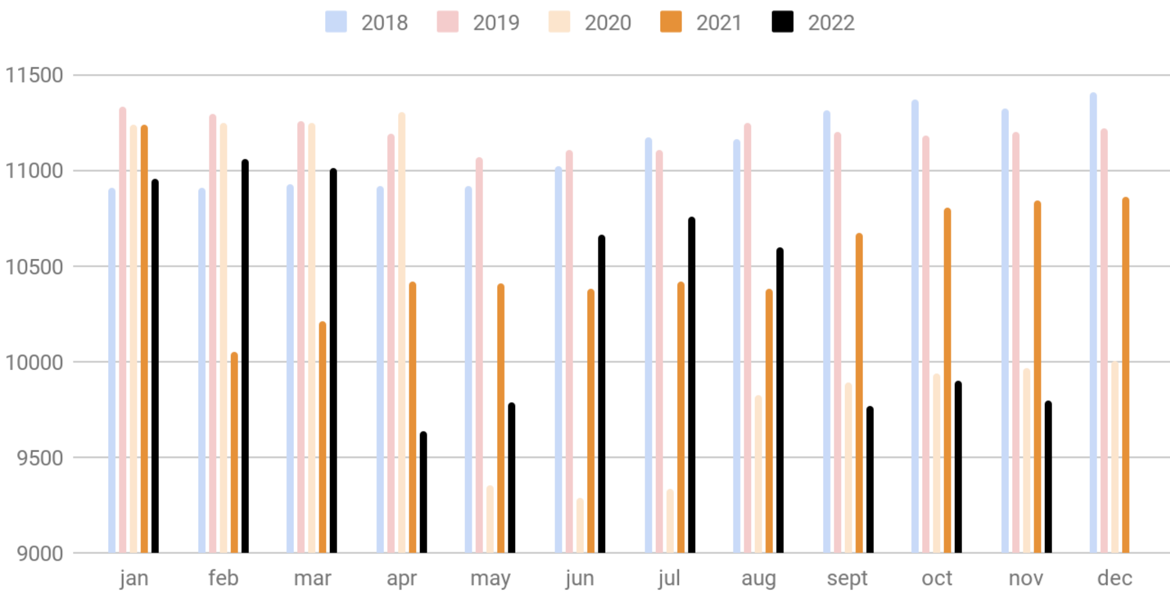
Among the new promising areas is Azerbaijan, Regina Lyanzberg believes. Long-term plans include the construction of a second 330-kV Derbent-Khachmaz line, as well as the parallel operation of the power systems of Russia, Azerbaijan and Iran, which can probably increase supplies to Azerbaijan. However, such plans are most likely to be implemented already beyond the horizon of 2023, Lyanzberg suggests.

## Chart 16: Russia Oil & Gas Exports ($bn, Annualised)

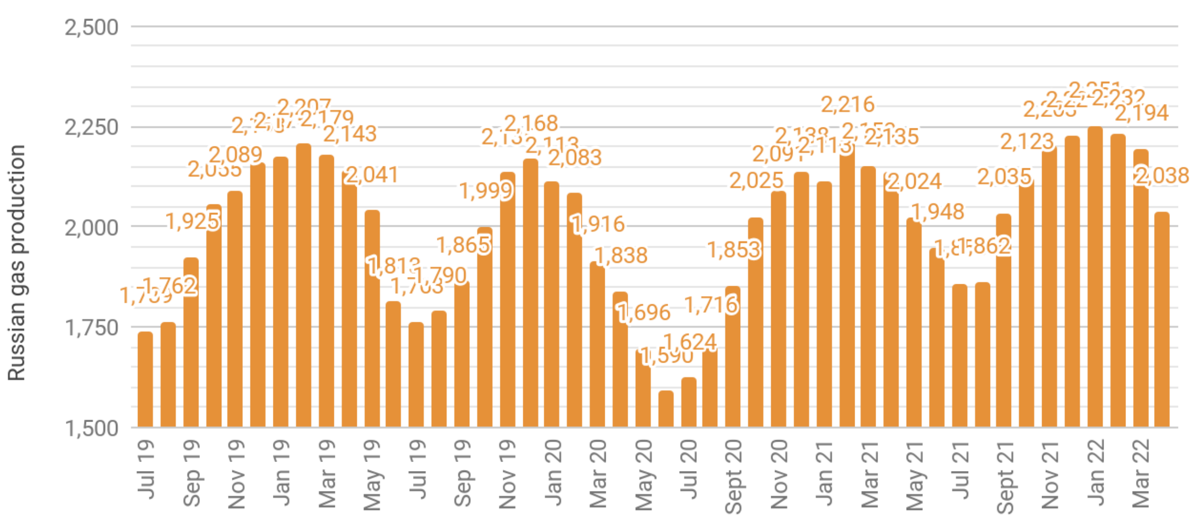


## Russian oil production (months) kmbd

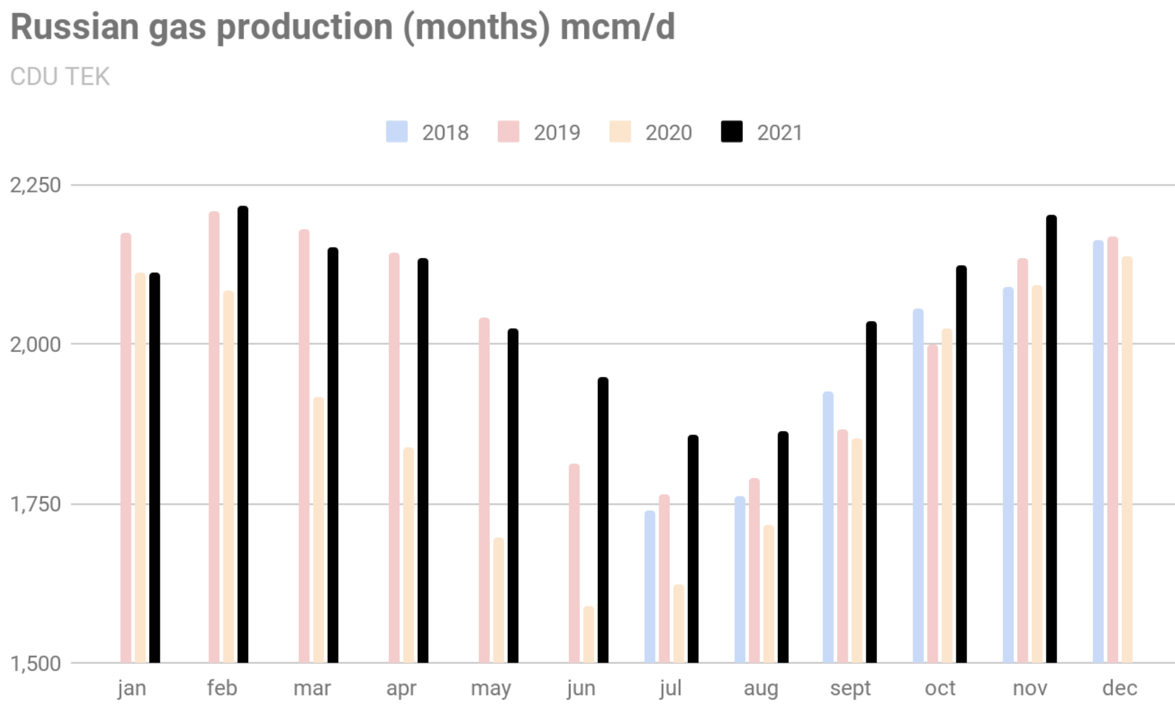
CDU TEK




## Russian gas production mcm/d




source: CTEK




## • Banking sector

**Russia's banking sector had by far its most profitable year in 2021 since economic growth fell to zero in 2013, and made record profits across the board. Those profits disappeared in 2022.**

The situation in the banking sector is uncertain, as the CBR stopped reporting bank sector results in February 2022; however, Russia's second-largest bank **VTB does not anticipate losses in the second half of 2022, though the bank will most likely post full-year loss**, chief executive officer of Russia's second-biggest lender Andrey Kostin said on the sidelines of the 15th Verona Eurasian Economic Forum in Baku in November.

Earlier, VTB CEO said he projected notable profit in 2023, adding that no dividend payments for 2022 were expected. Net profit of VTB Group under International Financial Reporting Standards (IFRS) soared 4.3-fold in 2021 compared with the previous year to RUB327bn.

**Russia's biggest lender Sberbank has become sustainably profitable and expects to remain profitable in 2023**, First Deputy CEO Alexander Vedyakhin said at a conference on Wednesday. "Sber has become sustainably profitable. We are on this stable trajectory, and I am sure that unless, God forbid, something happens, we will maintain stable profitability next year," Vedyakhin said. Sberbank's net profit in November grew by 22.7% to RUB124.7bn under Russian Accounting Standards, but for January-November the profit slid by 84.8% to RUB174.8bn.

**Comprehensive sanctions on Russia's financial sector were expected to have a substantial impact, but appear to have failed to achieve the desired effect.**

Despite sanctions on most financial institutions, including asset freezes, loss of access to the US dollar and the euro, and disconnection from the SWIFT payment infrastructure, the financial system has stabilised, mainly because of competent management by the CBR.

Bruegel estimates that close to two-thirds of Russia's banking system in asset terms has lost access to the US and/or European financial systems, and thus to the world's two most important currencies. Most large banks have been disconnected from SWIFT – a step long considered a 'nuclear option'.

Nevertheless, structural liquidity conditions have returned more or less to pre-sanctions levels, following a short period of stress in March 2022. In addition, various channels continue to enable Russian banks to interact with the outside world.

However, the financial system faces considerable challenges. According to the CBR, Russian banks lost close to $25bn in the first half of 2022, largely from foreign currency operations.

Russia's financial sector was hit by the shock of extreme sanctions imposed in March but the rapid reaction of the CBR narrowly averted a financial crisis, but nine months on and the sector has stabilised and is returning to profit.

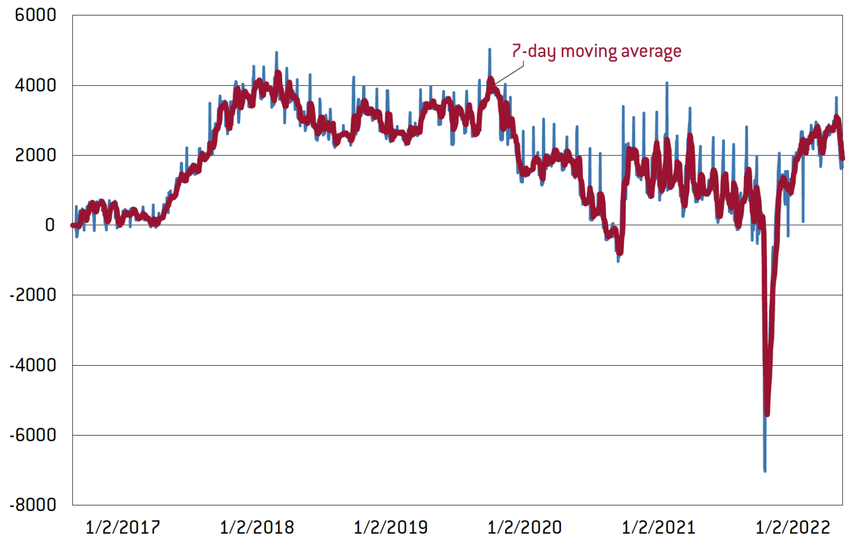
The losses of the Russian banking sector since the beginning of July have fallen from RUB1.5 trillion ($24.5bn) as of July 1 to RUB0.4 trillion ($6.53bn) as of November 1.

"The losses of the banking sector fell more than three times, from RUB1.5 trillion as of July 1, 2022, to RUB0.4 trillion as of November 1, 2022, thanks to improved net interest revenue and a reduction in the growth rate of extra reserve formation," the regulator said last month.

While Russia's banking sector will probably end 2022 with an overall loss, it is predicted to go back into profit next year.

It should also be noted that there are significant exemptions to financial sector sanctions, including for energy-related transactions via Gazprombank. These could be removed in the future as European imports of Russian oil and gas continue to decline.

**Figure 10: The banking system's structural liquidity surplus has returned to pre-war levels**




Source: Bank of Russia.

**Sber has resumed reporting its financial results under Russian Accounting Standards in October after a long pause caused by the war in Ukraine,** highlighting the return of health of the Russian banking sector.

"The November figures are strong as the trend seen in October continues. We interpret the return to financial releases and strong earnings in October-November as a signal that Sber has navigated 2022 challenges well," BSC GM said in a note.

The main results included:

- November Net income rose to RUB124.7bn (+2% m/m; +23% y/y)
  - helped by strong core revenue NII and Fees
  - OpEx optimisation – RUB64.3bn (-0.3% y/y)
  - Cost of risk at pre-crisis levels with non-performing loans (NPLs) at a low 2.3%
- capital adequacy ratio (CAR) above buffers set by the board.

The good results suggest the bank may pay dividends for 2022, after suspending those too.

This is the second strong monthly earnings for the bank, which BCSGM says suggests the banking sector is normalising.

Accounting for almost half the sector by itself, Sber's results are indicative of the recovery. Sber returned to a partial disclosure of financial results under RAS in October. The second release of results for November and 11M22 followed in December.

“The releases still lack some important lines, yet we see a strong trend of October extended into November with net profit of RUB125bn and ROAA of 4%,” BCS GM said.

Core incomes proved strong in the last two months, with November net interest income (NII) and fees of RUB216bn up 14% y/y thanks to stronger loan dynamics in a lower interest rate environment as well as lower funding costs, while client activity and acquiring growth supported fees, BCS GM reports.

“Importantly, Sber does not apply any of the forbearance measures introduced by the CBR for 2022,” the analysts added.

The capital adequacy ratio (CAR) of the bank is above buffers set by the board, and CEO German Gref indicated in the results that this makes dividend payments for 2022 possible.

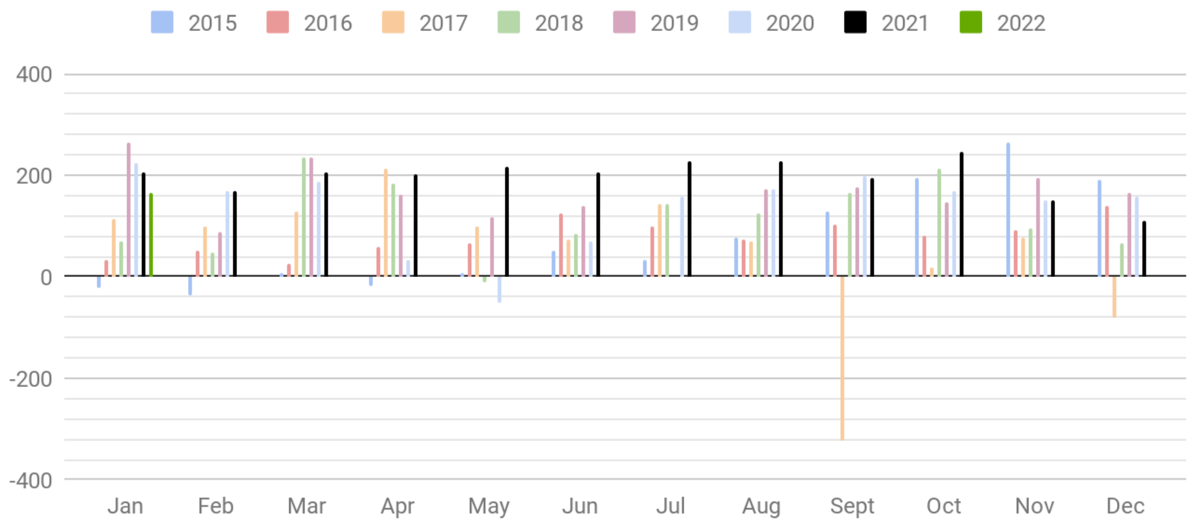
“While the press release lacked provisions and equity lines, it said that CAR levels improved in November, exceeding management buffers set by the board of directors in December 2021. More importantly, the CEO recently flagged a return to dividend payments in 2023, as the bank returns to normal functionality,” BCS GM said.

The cost of risk stayed low at 0.8% and 0.7% in November and October respectively – back to pre-crisis levels with NPLs low at 2.3%.

The improvement in operating expenses was also welcomed by analysts as an achievement and also supportive for the bank. OpEx was RUB64.3bn (0.3% y/y) in November and RUB589.8bn (-4% y/y) over 11M22.

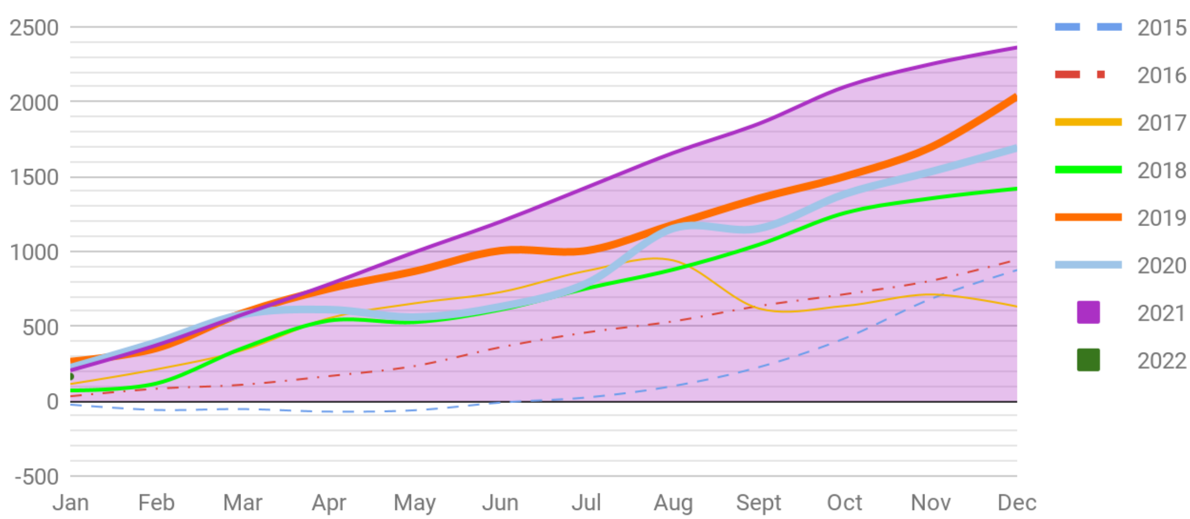
“We consider this cut in OpEx as quite an achievement, given it is hard to cut costs for Sber, in our view,” BCS GM said.

## Russia bank profit RUB bn (monthly profits)




source: CBR

## Russia bank profit RUB bn (cumulative profits)



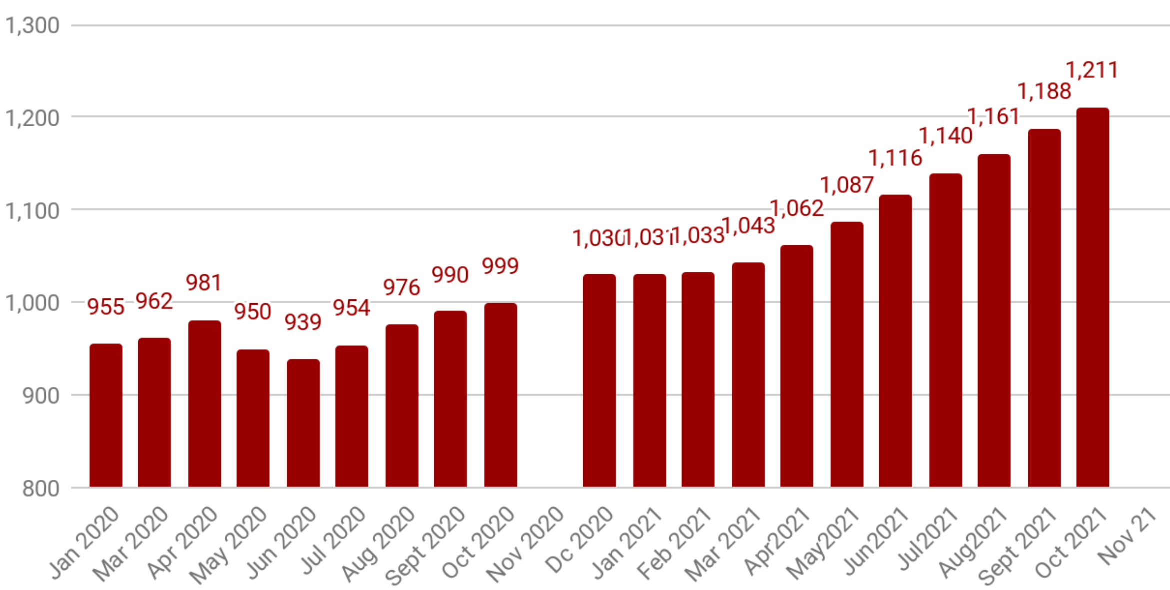

source: CBR

## Russia banks: Corporate vs Retail loans (RUB bn)


source: CBR

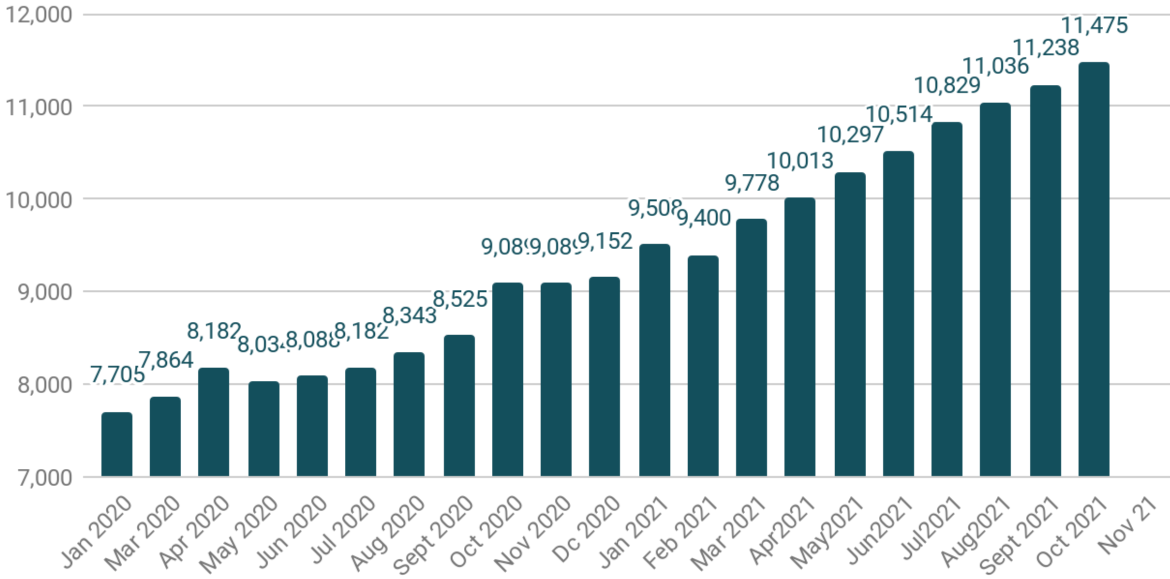
## Russia car loans RUB bn

source: CBR

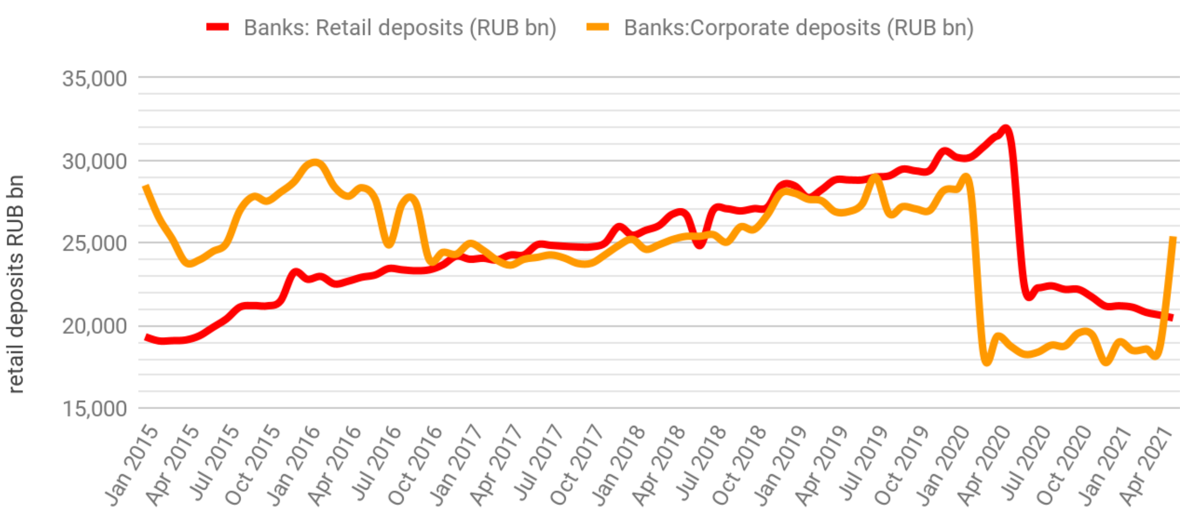


## Russia mortgage loans RUB bn

source: CBR




## Russia bank Corporate vs Retail despoits (RUB bn)




source: CBR

# • Commodities

**While European imports of Russian pipeline gas declined by more than 80%, shipments of Russian LNG to Europe ballooned by 50% during the first nine months of 2022.**

The imports of Russian LNG are part of a sustained push by the EU to replace Russian pipeline gas with gas in the form of LNG. Russian LNG sales are growing, including to Spain and Belgium and other countries that have been fully engaged in Nato and EU efforts to sanction Russia. Countries that previously did not import any Russian natural gas via pipeline are now buying Russian LNG.

Almost 80% of Russian LNG exports have gone to Europe and Asia. The country shipped an average of 2.78m tonnes of LNG per month in 2022, up from 2.62mn in 2021 and 2.56mn in 2019. In September 2022 alone EU countries purchased almost $1bn worth of LNG from Russia.

The demand for LNG in the EU will likely climb further in 2023. In 2022 the bloc was able to use Russian pipeline gas in the earlier part of the summer to begin filling its gas storage tanks before pipeline flows began to dwindle. Next year, no such buffer will exist.

The mad dash for LNG shipments has resulted in extensive traffic jams across Europe's regasification terminals where LNG carriers can offload their cargo. Imports of LNG have risen most in Spain, France and Portugal. However, many EU countries do not operate regasification plants. Spain operates six LNG terminals. And even with that capacity, more than a dozen vessels were queued off the country's coast in November waiting to offload their cargo.

The absence of a pipeline system connecting Spain to other European countries also means that countries like Germany cannot easily receive gas that arrives in Spain in the form of LNG. Plans to build additional pipeline infrastructure connecting Portugal and Spain to France and Germany are in the works, but will take several years to materialise. The global LNG market is likely to tighten significantly in the months to come.

An economic slowdown in China freed up considerable quantities of LNG for re-export to Europe, but Beijing announced in November that it would halt the sale of LNG to foreign buyers in an effort to reduce the flow of LNG out of the country. If China's economy picks up in 2023 then analysts say that will only tighten the LNG market further and keep prices high.

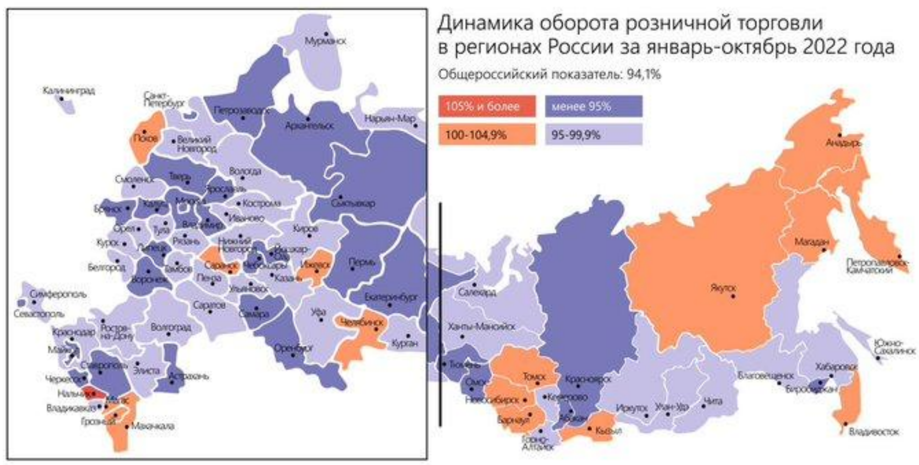
# • Sectors

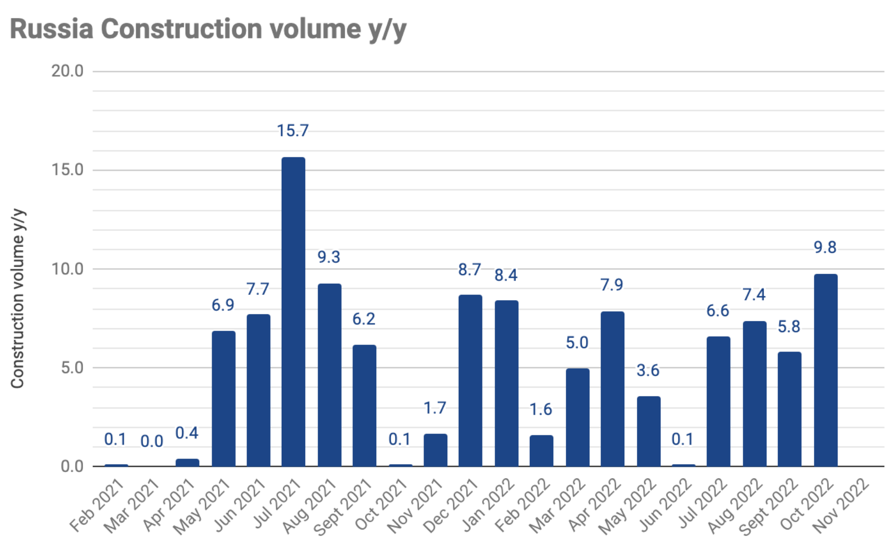
Economic activity has overall been steady following a strong decline in the second quarter of 2022. At the same time, data are invariably vastly mixed across sectors, in a sign of the ongoing structural shifts. Geopolitical and economic uncertainty constrains private investment and raises the share of government-supported projects. Overall, fixed capital investment is expected to slow down in 2023.

## Retail:

**Retail trade in Russia fell by 6% in January-October,** according to RosStat. Taking into account its 4% growth before the war, it fell actually by 10% during the 8 months of the war. It's a serious indicator of the population's impoverishment.

*Dynamic of Russian retail trade by region Jan-Oct 22 y/y %:*
(red >105%, orange 100-104.9%, light blue 95-99.9%, dark blue < 95%)



## Agriculture:

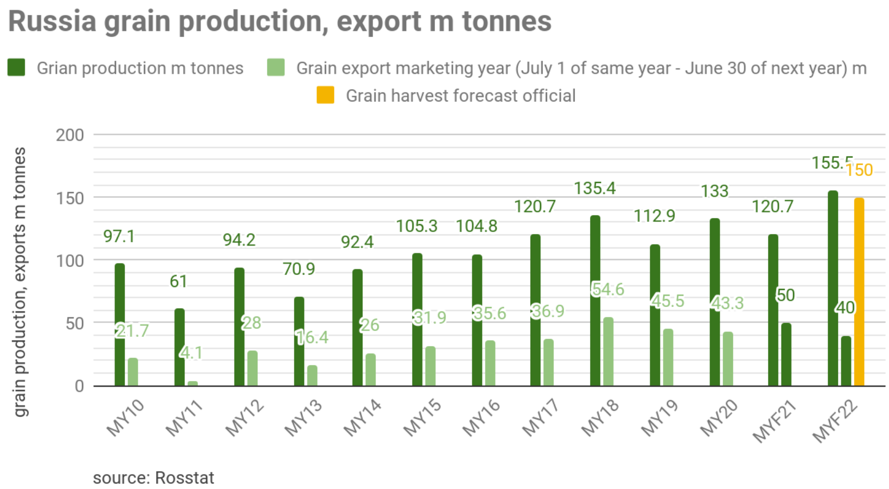
**Russia's grain harvest in the current agricultural year may reach 153mn tonnes, including 111mn tonnes of wheat, smashing the previous all-time high**, director of the Institute for Agricultural Market Studies Dmitry Rylko said in December. Rylko added that due to a decline in exports to Russia this year, a record-breaking wheat stock of 17.7mn tonnes could be formed by the end of the season. The forecast of the Ministry of Agriculture for the grain harvest in Russia in 2022 was 150mn tonnes, including 100mn tonnes of wheat.

Russia has sown 17.7mn hectares of winter crops compared to a 19mn hectare plan for 2022 because of weather problems, the Agriculture Ministry said in a statement on December 8.

**The volume of agricultural production in Russia in January-October 2022, according to preliminary estimates, increased by 5% y/y and amounted to RUB7.2 trillion ($117.9bn),** according to RosStat. In October 2022, the figure amounted to RUB1.31 trillion ($21.45bn). RosStat reported earlier that inflation in Russia for November 22-28, 2022 amounted to 0.19%. A week earlier, inflation in Russia was at the level of 0.11%.

**The high result for this year's harvest may be connected to the fact that Russia has stolen or destroyed $1.9bn worth of agricultural products in Ukraine.** The estimated 2.8mn tonnes of grain and 1.2mn tonnes of oil seeds were destroyed or stolen because of Russia's war against Ukraine, according to the Centre for Food and Land Use Research of the Kyiv School of Economics (KSE).

**Russia can harvest 83-90mn tonnes of wheat in 2023, Igor Pavensky, director of the strategic marketing department of railway grain transport operator Rusagrotrans**, said on December 9. "Being optimistic, if the weather is the same as during the harvesting season this year, we can reach 90mn tonnes," Pavensky said, adding that the main forecast of the company is moderate at about 83mn tonnes. The official said that winter sowing was fairly successful, with about 3% of poor quality crops, the same as in 2021. A serious frost and the lack of snow in the Orenburg Region and the eastern part of the Tatarstan republic are among the possible threats. The sown area will amount to 16.3mn hectares, after 17.1mn hectares in 2021.




## Automotive:

**By the end of 2022, only 14 out of 60 brands remained on the Russian car market,** RIA Novosti writes with reference to the Russian Automobile Dealers Association. Of the 14 brands remaining in Russia, only three are domestic: Lada, GAZ and UAZ. The rest are Chinese: Chery, Geely, Haval, Jac, Faw, Dongfeng, Changan, Exeed, Gac, Foton, Omoda.

**Sales of passenger cars and light commercial vehicles (LCVs) declined by 62% y/y in November to 46,403 vehicles**, according to the Association of European Businesses that oversees the industry.

In the first 11 months of 2022, the market contracted by 61% y/y to 0.55mn vehicles sold. (chart & chart) As followed by *bne IntelliNews*, sanctions imposed because of Russia's military invasion of Ukraine have brought the Russian car market screeching to a halt. However, Lada models from the largest Russian carmaker AvtoVaz posted some recovery in August and September, which was attributed to the launch of state-discounted car lease support.

Then in October Lada model sales dropped by 25% y/y. In November Lada remained the market leader, with 21,700 vehicles sold in November, but down by 18% y/y (and down by 49% y/y to 0.16mn vehicles for 11M22).

AvtoVaz's Lada Granta, which remains the only domestically assembled model on the Russian market, sold nearly twice as well as a year earlier and with 13,000 vehicles sold in November. The model is the only budget offering on the Russian car market and is also the beneficiary of the preferential car loan programme.

Chinese Haval remained the top-selling foreign brand, albeit down 7% to 4,500 in November, closely followed by another brand from China, Geely, with sales up by 24% to 3,500.

Amid an exodus of Western and Japanese carmakers from Russia, Chinese carmakers are already reportedly hard-pressing Russian dealers into lowering their purchase prices and also eyeing the takeover of vacant assembly capacities.

**Russian car producer AvtoVAZ expects the Russian passenger car and light commercial vehicle (LCV) market to shrink to 670,000-700,000 units in 2022, AEB reports.** In January-November, sales of new cars and LCVs in Russia dropped by 60.9% to 548,900 vehicles, the association said.

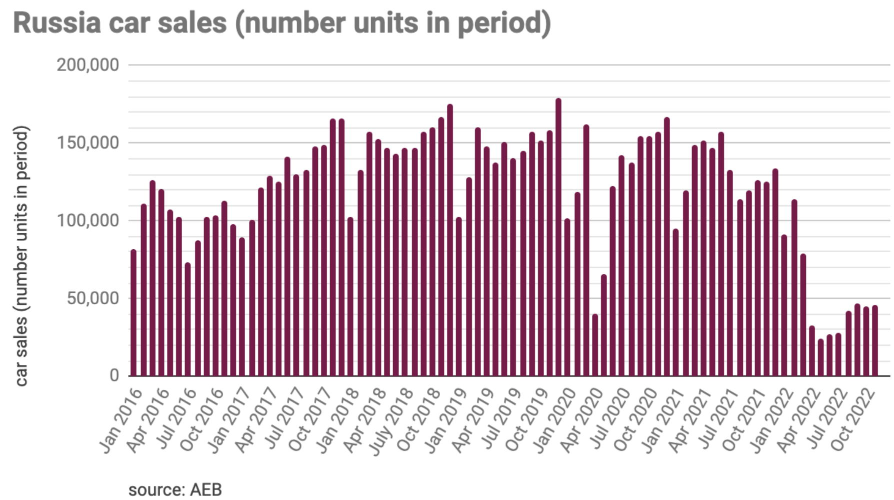
According to the Association of European Businesses (AEB), Russia's car market amounted to 1.6mn cars and light commercial vehicles in 2021.

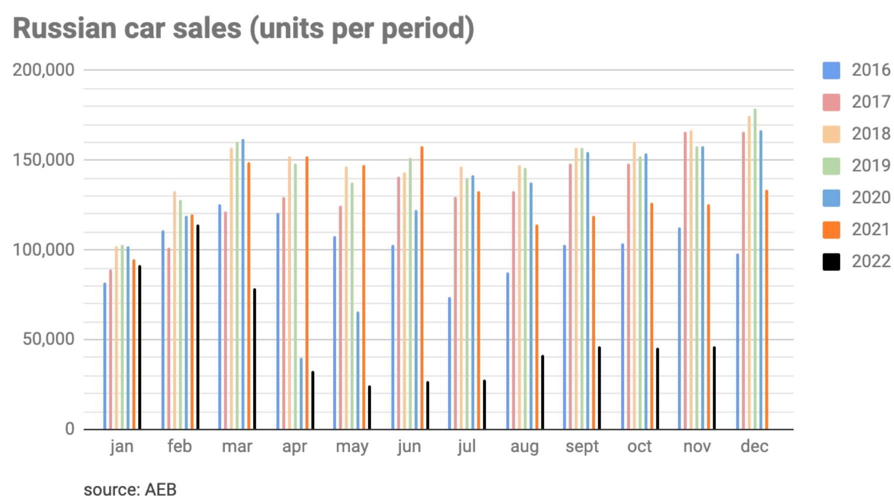
**AvtoVAZ president Maxim Sokolov said that in 2023 the Russian market for passenger cars and LCVs will be about 800,000 vehicles**, according to the baseline scenario.

**AvtoVAZ plans to export 20,000 vehicles in 2023.** Sokolov added that AvtoVAZ is going to resume export deliveries. According to him, in 2023 the company will be able to export about 20,000 cars. As he explained, AvtoVAZ is ready to supply car kits to Kazakhstan, and also plans to enter the markets of Belarus, the CIS countries and Africa.

**President Putin instructed the government to ensure constant control over formation of prices for cars** in order to prevent their unreasonable increase, the Kremlin said in a statement on its website the same day. "The government of the Russian Federation: to ensure constant control over the formation of car prices in order to prevent their unreasonable increase... The report date is until April 15, 2023, further – quarterly," the statement read.

Putin also has instructed the government to improve the affordability of passenger cars for Russians and to determine a target indicator that describes an increase in such affordability. The report is not expected until April 15, 2023, and then quarterly.




## Aviation:

**Russian airlines have removed 201 aircraft from the Bermuda registry during the first six months** after the sanctions were imposed on Russia, including 150 of the aviation workhorses made by Boeing and Airbus, *Kommersant* reported on December 8. That creates a fleet of around 300 Russian planes that can land at international airports.

The move is significant, as the re-registration of these planes in the Russian registry, which is now mandatory after the revocation of the airworthiness certificates by the Bermudan registry, does not mean the removal of the Bermuda registration.

Re-registration is impossible without the consent of the aircraft owners, and it is not profitable for them, since it makes it difficult for the courts as another approximately 500 planes in the Russian fleet are leased and Russia has refused to pay the instalments since March in a move that will cost plane-makers hundreds of millions of dollars.

Putin's new law will [allow Russian airlines to register in Russia planes leased from abroad](), and came into immediate force on March 13. The bill will create a new obstacle for leasing firms and lenders, which are seeking to recall the 500 planes currently leased by Russian airlines. Western sanctions imposed after Russia's invasion of Ukraine gave leasing firms until March 28 to repossess aircraft worth an estimated $10bn.

Aircraft with dual registration do not comply with international airworthiness regulations, as responsibility for the certification lies with the country of registration and is a specialty of Bermuda, The Bell reports.

Without the Bermudan registration, Russian planes are refused permission to land at most international airports. Even Turkey has banned Russian planes from flying in its airspace.

Of the planes removed from Bermuda's registry, 105 belong to the Aeroflot group of airlines (Aeroflot, Rossiya, Pobeda), followed by Utair (36), Azur Air (9) and S7 ( 6). All of these are "clean" planes, purchased and paid for outright by the carriers or owned by Russian lessors, which are not subject to arrest at foreign airports, whereas the unpaid planes are.

Including the Russian-made Sukhoi Superjet, there are now a total of 300 aircraft in Russia capable of flying abroad. In 2019-2021, on average, from 300 to 500 aircraft of Russian airlines regularly flew abroad.

International air transportation in Russia is now more profitable than domestic, so airlines will put all planes free from double registration on international routes. Consequently, rates on domestic routes will rise, and the costs of companies that were previously forced to carry people abroad on small-capacity Superjet will decrease, aviation industry experts say, reports The Bell.

The increase in ticket prices can be compensated by state subsidies, but so far only RUB25bn has been approved for 2023 against RUB100bn in the current one.

On the other hand the ticket prices on international routes are now expected to fall. Carriers predict that the shortage of carrying capacity will remain at least until 2025, after which retired foreign-made aircraft will be increasingly replaced by the Russian-made MC-21 and Sukhoi Superjet using Russian engines.

## IT Sector:

**Russia's Internet economy will increase by 24% in value terms in 2022 compared with 2021** to RUB11.8 trillion ($187bn), whereas the growth rate will drop almost two-fold compared with previous years, director-general of the Russian Association for Electronic Communications (RAEC) Sergey Grebennikov said in a report at the Russian Internet Week 2022 on December 12.

Compared with previous years, growth rates will drop almost two-fold, he noted, adding that the growth amounted to 41% in 2020 in annual terms, and 42% in 2021.

The decrease in growth rates in 2022 is connected with the still unfinished process of adjustment to new instruments and solutions, the lack of competitive Russian analogues in a number of solutions, initiatives in the area of regulation of the advertising sector, as well as to consumers shifting to a policy of frugality, according to the report.

RAEC believes that in order to restore the growth rate of Runet in the short term it is necessary to ensure incentive regulation, primarily by minimising the number of regulatory initiatives that have an ambiguous impact on the industry. Moreover, it is necessary to maintain support of the sector until the full completion of the process of adjustment to the new environment, with a focus on the sectors of internet advertising and digital content.

"That said, it is impossible to fully return to the 'pre-crisis' growth rates without completion of the period of turbulence and stabilisation of the macroeconomic situation," according to the RAEC's report.

**The war in Ukraine has been a boon to Russia's e-commerce,** as this has become the main channel for Russians to buy the international goods that have disappeared from the shelves. The leading e-commerce companies have been actively developing parallel import channels of supply, as many of them had already diversified into other markets and developed the logistical ability to import goods.

The volume of sales by Russian e-commerce expanded 1.5-fold y/y in the first half of 2022 to RUB2.2 trillion ($36.4bn), the Association of Internet Commerce Companies said on August 11, reports TASS.

"Total online commerce amounted to RUB2.3 trillion ($38.1bn) (an increase of 43% y/y) – this was the sum spent by Russians on Russian and foreign online platforms. The domestic market accounts for RUB2.2 trillion from this amount, which is 50% more than in the like period of the last year," the association said, as cited by the Russian state-owned newswire.

The top five positions in the rating of goods purchased online comprise electronics and household appliances (22% of the total online commerce volume), followed by furniture and home goods (17.7%), apparel and footwear (13.9%), foods (13.5%) and beauty and wellness products (7.5%).

Following the imposition of sanctions and the voluntary withdrawal of hundreds of international brands, Russians have turned to the e-commerce sites to buy now hard-to-find foreign brands. The leading sites, including Wildberries and Ozon, have been setting up parallel imports, sourcing goods from non-participating countries like Turkey to provide their customers with the international brands.

**The volume of online piracy in Russia may grow significantly in the near future,** the press service of the RAEC told TASS, citing forecasts for the development of the Internet economy in Russia for 2023. Experts interviewed by TASS believe that piracy volumes could double and reach $60mn. The press service clarified that the Anti-Piracy Memorandum signed between major search engines and copyright holders of video and audio content, which was extended in 2022, can protect it. However, the memorandum does not cover, for example, games or e-books.

**Representatives from the state may appear on the boards of directors of Russian IT companies.** The mechanism for controlling Internet companies was proposed by the Centre for Strategic Research in December.

State representatives on the boards of directors, according to the authors of the initiative, are needed to control foreign investments in IT companies and "significant corporate actions" in order to protect the IT sector from foreign influence. Experts call the idea “the lesser of evils” compared to the bills of Deputy Gorelkin, who proposed limiting the share of foreigners in news aggregators, online cinemas and classifieds.

The state has already effectively taken over Yandex, Russia’s largest IT company. It was split into two in December and former finance Minister Alexey Kudrin was appointed to run the Russian part of the company, while the founders took control of the international part of the business. Yandex had already agreed to give the state a “golden” share well before the war started, which gave the Kremlin a veto on its decisions.

This mechanism was developed as an alternative to the draft laws of Deputy Anton Gorelkin, who proposed limiting the share of foreign capital to 20% in news aggregators, online cinemas and classifieds. According to the CSR, limiting the share of foreigners in the IT sector does not correspond to its “special nature”. The measures proposed by the centre, on the contrary, according to the authors of the report, will allow "preserving the investment attractiveness of the Russian IT sector." The CSR report was prepared after Ivan Tavrin's KCG bought Avito from Prosus. The resource was sold more cheaply than it could have been, including because of Gorelkin's bill, reminds *Kommersant*.

## Utilities and energy:

**Russia's power demand was flat in November and prices were down a bit.** November spot prices were down by 2.5% y/y, while consumption was up 0.4%, according to consumption and power price statistics from the Market Council. The data reveal a lack of direction in European Russia, while wholesale spot power prices in Siberia (due to low hydrology) were up a great deal (+28.1%), so mixed. Sales of electricity account for roughly 60% of gencos' revenues, ex-DPMs. Hence we track the pricing and demand levels. In isolation, spot prices translate into flat to declining margins from electricity sales. However, in the power market framework that separates power and capacity payments, gencos may source a significant part of their revenues from stable capacity flow, which was indexed by 25% y/y in 2022 and analysts expect this will go up further by 15% in 2023.

**Russian nuclear state corporation Rosatom and about 20 countries are negotiating new projects,** head of Rosatom Alexey Likhachev said in an interview with the Rossiya-24 TV channel on the 15th anniversary of the creation of the state corporation. This includes long-standing partners of the corporation such as Bangladesh, India, Egypt, China and Turkey, he added. Rosatom is marking 15 years since its establishment. It is one of the top three in the nuclear fuel cycle services market, ranking second in uranium mining, first in uranium enrichment and third in fuel production. Rosatom is also the world leader in terms of the number of power units of nuclear power plants (NPPs) in the portfolio of foreign orders and accounts for 70% of the global NPP construction market.

## Metals:

**Russia's steel sector surprised this year as despite the sanctions, logistical bottlenecks and contracting economy, steel production was up 4.8% y/y during 10M22** while general economic growth was down 2.1% in the same period, BCS GM reports.

Normally steel production is closely associated with economic activity. Moreover, this year Russian steel exports have been hampered by sanctions on things like shipping that have both reduced exports and also clogged up Russia's railways. Many companies are seeking to re-orientate exports to Asia by sending their goods by rail across the country in bulk.

The uptick has been driven by surprisingly strong growth in domestic construction, which made up three quarters (75%) of demand, and pipes (12%).

Residential development projects have remained largely unaffected by the war in Ukraine and the leading companies in the sector have been reporting strong results. The demand for steel in construction was up 1.2% y/y in the period.

The growth in demand for pipes was even stronger, up 40% y/y in the period, and this demand is likely to remain very high for the foreseeable future as Russia needs to re-orientate its entire gas pipeline infrastructure from Europe (70% of the current capacity) to Asia as a result of the sanctions.

“The main bright spot has been the energy sector, where several mega-projects have pumped up demand for pipe,” BCS said in a note. “Some notable examples are Gazprom’s pipeline initiatives, as well as local gasification programmes and Rosneft’s Vostok Oil. However, the most important steel demand driver has always been construction, which has remained on a growth path thus far.”

BCS GM asks whether the current trend is sustainable, as the numbers of square metres additionally planned and that already have permissions granted has been flat y/y. At the same time, manufacturing, which consumes about the same amount of steel as pipes, has also been very weak this year. With the risk of a construction slowdown in 2023 the future remains uncertain for the steel sector.

**The European Commission proposed sanctions on Russia's mining industry for 2023 in December**, although the details are not clear yet. The mining industry was largely unsanctioned in 2022, as Russia is too deeply integrated in the international metals market.

The EC is proposing a potential ban on new investments in the Russian mining space according to European officials under the as yet unfinished ninth sanctions package. The restrictions will have a number of exceptions for "specific products", Reuters notes. For example, so far most of Russia's aluminium, nickel, PGM and steel production has been exempted.

One metal of special note, dominated by Russia, is titanium, used in plane-making. European aerospace giant Airbus intends to divest Russian titanium supplies within months, Prime reported citing a statement from the CEO of Airbus Defence & Space, Michael Schoellhorn.

So far titanium supplies have not been directly sanctioned by the West for Russia's military invasion of Ukraine. But US plane-maker Boeing previously in March announced its suspension of purchases of titanium from Russia.

Previously, Boeing was set to deepen its co-operation with VSMPO-Avisma, Russia's titanium producer. As followed by *bne IntelliNews*, the US major in 2018 intended to spend $27bn on direct purchases in Russia out to 2038, with $18bn allocated to titanium purchases.

Until now the international plane-makers have been relying on stockpiles of titanium, and it remains unclear where they can source more non-Russian supplies of the metal.

All in all, the ban could be agreed upon by the end of next week, as European authorities hope. Separately, the new sanctions package might include the restrictions on three more banks' transactions, as well as against 180 individuals, and export controls on civilian technologies.

## Commodities:

**Tighter oil market in 2023**
There is still plenty of uncertainty over Russian oil supply given the EU's ban on Russian crude oil and refined products. However, we believe that Russian supply will fall significantly early next year – in the region of 1.8mn bpd y/y in the first quarter. This supply loss coupled with continued OPEC+ supply cuts suggests that the oil market will tighten over the course of 2023. US supply growth will not be able to fill the gap, with US producers showing a lot more capital discipline. As a result, we expect ICE Brent to average $104/bbl next year.

**European natural gas prices to remain elevated in 2023**
This winter appears as though it will be more manageable for Europe due to the late start to the heating season. This left European natural gas storage virtually full in mid-November. However, 2023 will be a tough year for the European natural gas market. It is unlikely the region will be able to build storage at the same pace as seen in 2022. Annual Russian gas flows will fall in the region of 60% y/y, even if flows remain at similar levels to what they are currently. Unfortunately, the liquefied natural gas (LNG) market will not be able to fully offset losses. Therefore, demand destruction will need to continue to ensure adequate supply for the 2023/24 winter. In order to see this demand destruction, prices will have to remain at elevated levels. We forecast TTF to average €175/MWh over 2023.

**Demand woes take centre stage for aluminium in 2023**
Aluminium prices have been highly volatile this year due to the Russia-Ukraine war, logistical issues, increasing recessionary fears and the Covid-19 pandemic. Looking ahead to the first quarter of next year, the risk for aluminium prices will be mainly to the downside, with the prolonged war in Ukraine, rising energy prices, low gas availability, high inflation and weakening downstream demand all adding to the bearish outlook for the lightweight metal. In the short term, the market's focus will remain on the bigger macroeconomic and demand-side problems, with prices predicted to slide further to $2,150/tonne in the first quarter of 2023. We believe a recovery in price should start in the second quarter, although any recovery is likely to be slow.

**Wood** came under pressure from sanctions, rising costs, and European sanctions on a number of wood imports from Russia came into force in the summer of 2022. This significantly changed the business of Segezha, Russia's biggest paper and pulp concern, which historically exported a sizable part of its products to Europe.

Ruble appreciation and rising costs ate up all the gains the company made in 1Q22. Analysts project the cost trends to persist, hence the BCS GM 3Q22 revenue estimate is effectively flat y/y, while EBITDA and earnings are down substantially.

"We expect things to get better in 2023, when the company completes transition to new markets and a seasonal construction period begins, driving up demand for wood products," BSC said in a note.

## Construction:

**Russian construction has been one of the surprises in 2022 as growth has been strong** and has supported both industrial production numbers and related sectors like metallurgy. The volume of residential construction grew by over 38% in Russia in the first half of 2022 compared to the previous year.

There was a brief hiccup in June when construction volume growth fell to almost zero, but a month later the sector went back to work. The trend continued into October, when construction output in Russia increased several percentage points to reach 9.6% in October compared to the same month in the previous year.

While construction is expected to cool in 2023 as the economy starts to stagnate, it is also one of the sectors that is likely to continue to enjoy strong state support, as it is one of the three big drivers of economic growth.

However, at the same time the CBR has expressed concern that mortgage borrowing, egged on by a government subsidy programme to keep interest rates affordable, has led to the beginnings of a bubble, so the CBR is likely to tighten borrowing conditions somewhat in 2023.

The 2022 programme of discounted mortgages at a rate of 7% was due to end in Russia at the end of 2023. Both the CBR and the Accounts Chamber have repeatedly called for the scheme to be cancelled. However, President Vladimir Putin recently announced that the programme would continue, albeit at a slightly higher rate of 8%.

These discounted mortgages are causing Russia’s real estate market to overheat. The primary and secondary housing markets are unbalanced (the price difference between a new apartment and a “maintained” apartment was 40% in December).

Subsidies have made housing more affordable for more citizens, who have decided to take out mortgages now rather than wait. Demand has risen sharply – faster than supply can adapt – and prices are soaring. In Moscow, it is now impossible to buy a comfort-class apartment in a new building without taking out a mortgage.

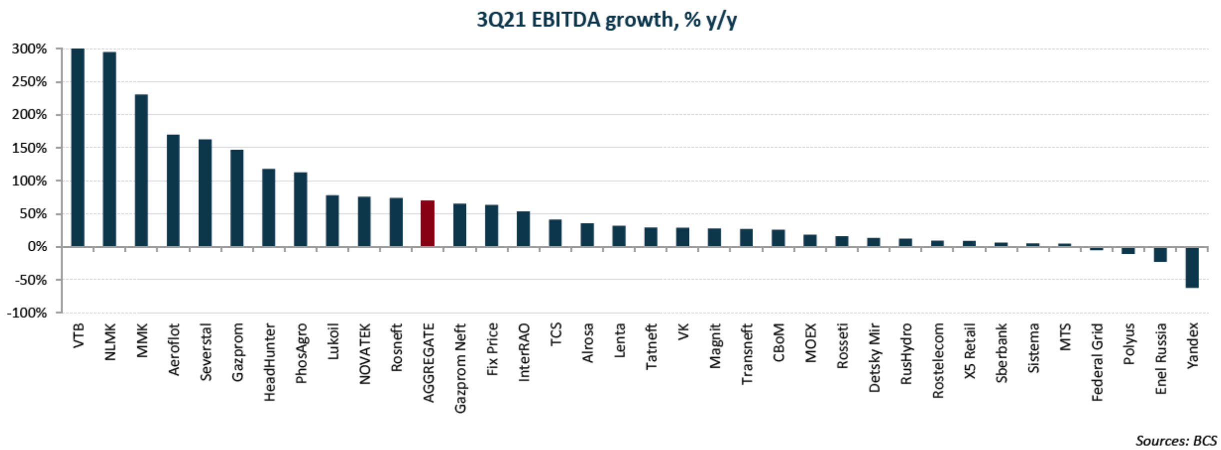
However, this bubble is unlikely to burst, according to independent financial analyst Sergei Skatov: developers have already sold more than 51% of the housing due to come onto the market by the end of 2023. They need to sell a further 10-20%, which is entirely achievable even if demand falls to summer levels. Defaults on mortgage portfolios could also burst the bubble, but with a failure rate of just 0.4% (and 0.15% in the primary market), this is also unlikely, Skatov said.

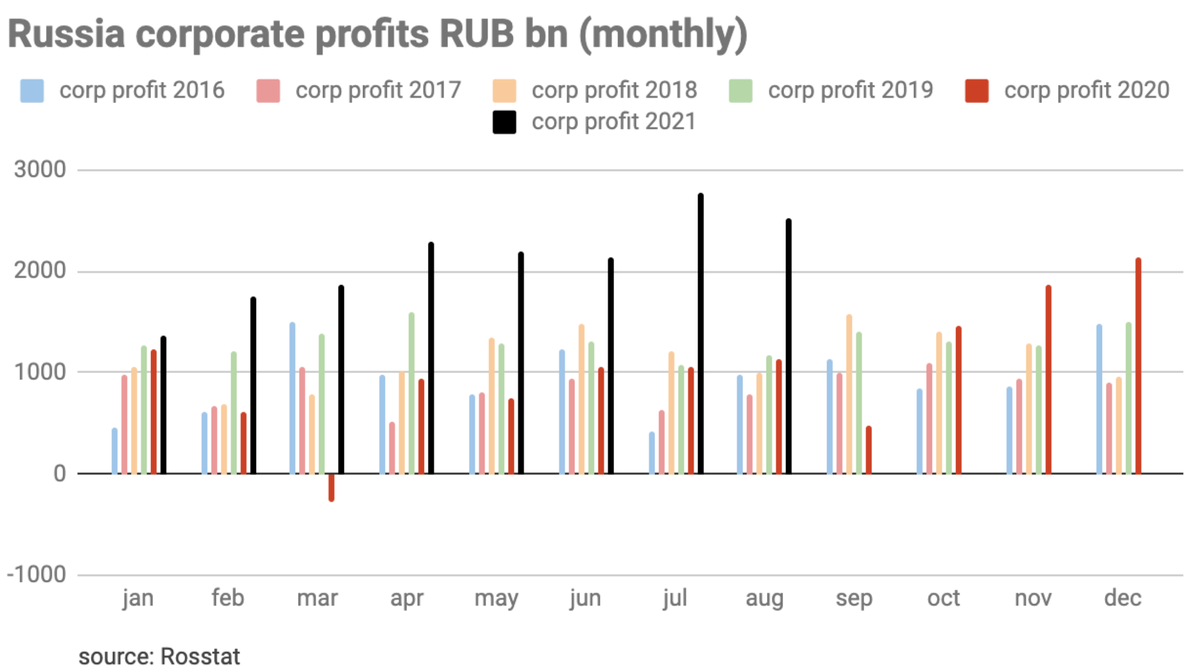
The demand for new housing, especially in the biggest cities, remains high and the largest developers continue to develop new projects.

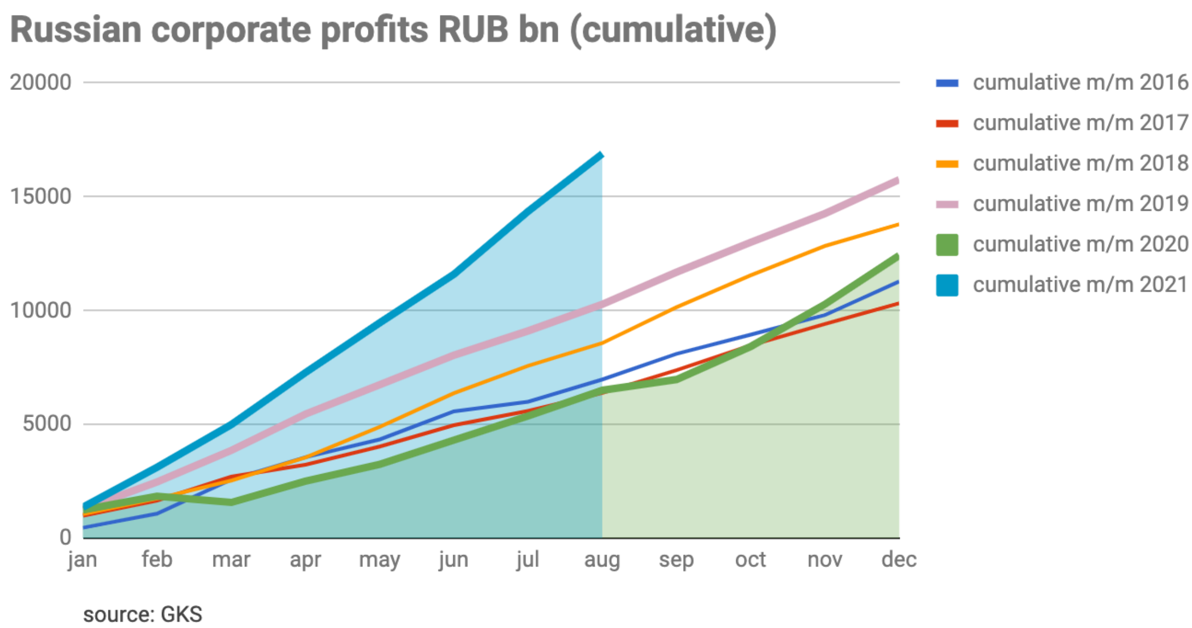
In one of the first signs of the new realities, demand for luxury homes in Moscow fell to its lowest level in five years in December, according to research by real estate company NF Group.

The number of property sales in so-called elite new builds in the Russian capital fell 44% y/y, from 1,620 sales in 2021 to just 900 in 2022, the lowest number recorded for five years. A drop-off in demand in light of the "geopolitical situation" and the economic crisis was anticipated, NF Group analysts said.

At the end of 2022 the CBR also reported that transactions on the secondary market were also slowing down as consumer confidence was affected by the partial mobilisation in September and the growing concerns about the war.






**The Ministry of Construction has proposed a new set of regulations for individual housing being constructed within cottage complexes that will boost construction next year.**

# 6.0 Markets Outlook

**The Russian equity market had its best year in a decade in 2021** and is expected to just as well in 2022. The dollar-denominated Russia Trading System (RTS) returned around 30% on the year in 2021, including a 20% sell-off in the last two months of the year.

## • ECM

**In Russia the “fear index” hit a historical high in 2022 and the Russian stock market was more volatile than during the pandemic years.**

The RVI index (an indicator of the volatility of the Russian market, which is also called the “fear index”) reached a maximum of 169.96 points at the end of March. This is the highest figure since November 2013 for this indicator.

For comparison: in March 2021, the value of the RVI index was 30-34 points, and in March 2020, during the pandemic crisis, it reached about 129 points.

By the end of 2022, the RVI value stabilised and dropped to 39 (as of December 30), which still remained higher than a year ago of 30-32.

Other indicators of the Russian stock market also showed the worst values since 2008. Thus the ruble index of the Moscow Exchange (which includes shares of the 42 largest Russian companies) lost almost 45% during the year, and the dollar RTS lost almost 40%.

In conditions of increased volatility, investors' holdings in Russian shares turned out to be the least protected – some securities lost more than 50% of their value.

Foreign markets were also in the red – the S&P 500 lost about 20%. Simultaneously, infrastructural risks materialised: the foreign assets of Russians were frozen, first due to communication problems caused by sanctions against the Russian financial sector, and then due to sanctions against the National Settlement Depository (NSD) that holds the foreign assets of Russian investors.

At the end of 2021, Russian shares were the best performing in the world, but that changed abruptly after the invasion of Ukraine. In 2022, the quotes of almost all Russian securities showed a significant decline and foreign investors have been barred from withdrawing their money completely.

In the first week of the new year the government announced that foreign investors could only withdraw their money if they were willing to sell them at a 50% discount. And even then, the proceeds of a sale would be converted into rubles and held in special bank accounts. If the investor then wanted to expedite repatriation and take this money out of the country in dollars – for which special permission from the Central Bank of Russia (CBR) is needed – then the investor would have to make an additional “voluntary” contribution to the budget of 10% of the value of the shares.

On top of the crash in share prices, a number of companies refused to pay dividends, which also led to a reduction in the yield of securities for investors.

The annual returns from Moscow exchange index since the beginning of the year have been approximately minus 40%, BCS GM reports. This is the worst indicator since 2008, when the index fell by 60%.

The maximum drop was observed in companies that suspended the payment of dividends, led by Russian banks, which the CBR advised to cancel distributing profits by dividends.

For example, the shares of state-owned VTB fell by 66% over the year, and its sister bank Sberbank was down by 52%.

In addition, there was a significant drop in technology companies. The shares of leading employment agency HeadHunter fell by 69% and tech giant Yandex plunged by 60%. National airline Aeroflot was down 58% and gold miner Polymetal by 72%.

The shares of companies that earn the majority of their revenue in the domestic market turned out to be more stable. Supermarket giant Magnit saw its shares tumble by only 20%, while leading mobile phone company MTS took a 21% hit. The shares of fixed line operator Rostelecom were down by 35%.

A few shares even gained in value. Fertiliser maker PhosAgro saw its shares rise by 7%, as fertilisers have been exempted from sanctions as part of the efforts to avoid a global food crisis.

Liquid and in profit, PhosAgro continued to pay dividends, and global fertiliser prices rallied on the warnings of a food crisis, making these shares something of a safe haven.