Russia Economic Review

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Steps to normalise relations with Turkey and relatively upbeat macroeconomic data for June provide a glimmer of hope for an economy struggling to re-establish robust growth.

- After almost of a year of "soft" confrontation between Russia and Turkey the relationship has finally started to move towards normalisation, helping not only to decrease geopolitical tensions in the region, but also to boost Turkish tourism – one of the pillars of Turkish economy – in the hope of encouraging the return of Russian tourists.
- While weekly inflation at the start of July accelerated to 0.4%W/W, this was predictable because of the annual communal services tariffs hike, which traditionally takes place at this time. We think that this year's hike will interrupt the disinflationary trend for about two to three months.
- The manufacturing PMI in June rose above 50 points for the first time since November 2015. Along with the services PMI, which at 53.8 was close to the highest level in three years, this provides hope of continued recovery.
- While car sales decreased by 12.5%Y/Y in June, this was still better than the previous month and the Bloomberg consensus forecast.
- Foreign reserves grew by almost 10%Y/Y. On the other hand, the widening fiscal deficit (4% of GDP in the first half of the year) suggests a strong probability that the government will need to draw from the Reserve fund, which in June was worth $38.2bn, down more than 50%Y/Y.

A move in the right direction: normalisation of Russian-Turkish relations

On 29 June, a 45-minute telephone conversation was held between President Putin and Turkish President Erdogan following the writing of a letter of apology by the latter regarding the death of the Russian pilot of the warplane shot down by the Turkish military last November. The apology was accepted and, as a result of the talks, the parties agreed on immediate actions to normalise bilateral relations. This was followed by an announcement from the Russian government on the lifting of the import ban on Turkish agricultural products and "turning off" the administrative warnings issued toward Russian travel companies to prevent them from selling tours to Turkey, on the ground that Russians' lives were in danger when they were in the country. And while the import ban diminished the scale of trade between two countries, administrative sanctions, such as the travel warning, which in reality was a ban to sell tours to Turkey, had probably hit the Turkish economy even more. In fact, after Germans, Russians were previously the second largest group of tourists to the country with around 4 million tourists annually visiting Turkish resorts. So, not surprisingly, the start of the normalisation of relations was warmly welcomed in both countries and beyond, not only because it should dramatically lower geopolitical tensions but also because it will have a positive effect on the Turkish tourism industry, which accounts for about 12% of Turkish GDP and therefore may contribute to economic growth.

Annual communal tariffs' hike on 1 July adds inflationary pressure

While still in line with the Bloomberg consensus forecast, inflation in June accelerated to 7.5%Y/Y from 7.3% a month earlier. And while this level is about half the inflation rate a year earlier, inflation still remains far from CBR's target of 4% and continues to weigh on consumption. Compared to the previous month, overall consumer prices rose 0.4%M/M. Food inflation in June was 6.2%Y/Y (0.1%M/M) and 6.5%Y/Y (0.3%M/M) without vegetables and fruits. On the other hand, non-food prices rose by 8.5%Y/Y (0.5%M/M), and services prices by 7.9%Y/Y (0.6%M/M). Core inflation in June was 7.5%Y/Y, the same as a month ago, and 0.4%M/M – down by 0.1ppt compared to May.

However, inflation is typically affected by the annual increase in communal tariffs, which is traditionally executed in July, and while variations exist between regions, this time around costs of electricity, water and gas increased by 4% on average. Indeed, in Moscow tariffs grew by 7.4% (or by 200 RBL which is equal to 300 JPY) and in St Petersburg the upper limit for the tariff hike was 6.5% - markedly higher than the average. While we expect that lower prices on seasonal vegetables and fruits will eventually help to mitigate the impact of the tariff's hike, some inflationary pressure will probably persist for the next 2-3 months. Weekly inflation as at 4 July accelerated to 0.4%W/W (the highest rate this year) reflecting again, the tariff's hike, after the weekly inflation rate stabilised from the beginning of year at 0.1-0.2%W/W.

Manufacturing PMI surprised on the upside. Services PMI around highest levels in over three years

The manufacturing PMI in June came in at 51.5 up by 1.9pts compared to the previous month and 1.5pts above the Bloomberg consensus. It is also was the highest level since November 2014. The sub-indices of production output, new orders and employment grew, suggesting that the Russian manufacturing sector started to gain momentum and we expect a moderate growth of industrial production to continue in coming months. Purchasing activity is reported to be at its highest in three years. And the survey suggests that the increase in new orders is mainly driven by domestic orders, which also suggests that the situation on the domestic market and consumer sentiment is improving.

Compared to the manufacturing PMI, which was above 50pts for first time this year, the services sector PMI has shown more promising results, being stable above 50pts since February. And June's services PMI of 53.8pts provided an upside surprise with the second highest result in more than three years, having reached 54.2pts in April 2016. The services PMI also rose by 2.3pts compared to May's figure and was above the Bloomberg forecast by 1.6pts to leave the composite PMI at 53.5pts – the highest level in three years.

Car sales decreased, but less than expected

While car sales in June decreased by 12.5%Y/Y, the result was still better than the previous month (-14.5%Y/Y). The Association of European Businesses, which publishes monthly Russian car sale statistics, forecasts car sales to decline by 10.4%Y/Y in 2016 reflecting the fact that sales in the first half of the year failed to improve on the double-digit rate of decline. At the same time the Association is expecting a slowdown of the downward trend to about 6-7% in the second half of the year. Over the first six months of 2016 car sales decreased by 14.1%Y/Y.

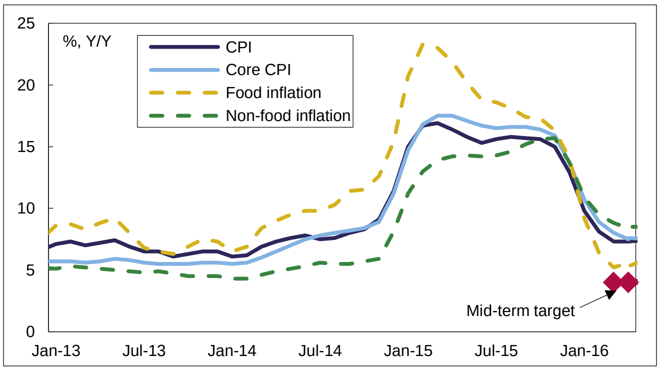
As it was in the previous months during the crisis, locally produced cars remain popular, not least because import prices rose markedly due to the weaker rouble. The trend has been maintained in June, when nine of the ten best sellers were produced in Russia. Japanese car brands are traditionally popular in Russia and Toyota's Camry was the seventh most popular in June while the same brand's RAV4 was also seventh by sales for the first half of the year. Despite the still tight economic situation and generally low appetite for consumption, a car market where Jaguar sales more than doubled in June compared to a year earlier once again suggests that Russians' natural resilience to austerity is a part of the national character.

Foreign reserves in June increased by almost 10%Y/Y

While foreign reserves in June totalled $393.7bn, up by 9.5%Y/Y, they were still markedly lower compared to the pre-crisis peak near $600bn in 2008 and levels above $500bn in much of 2011-2013, and well below the central bank's (CBR) target of $500bn. Nevertheless, oil prices, hovering around $50pbl, and the relatively stable rouble, are allowing, at least at the moment, the CBR to feel comfortable with the current level of reserves. We think that there will be no dollar-buying interventions unless the rouble appreciates significantly (which is highly unlikely considering increased market volatility amid Brexit) and therefore the dynamics of the forex reserves this year won't notably change.

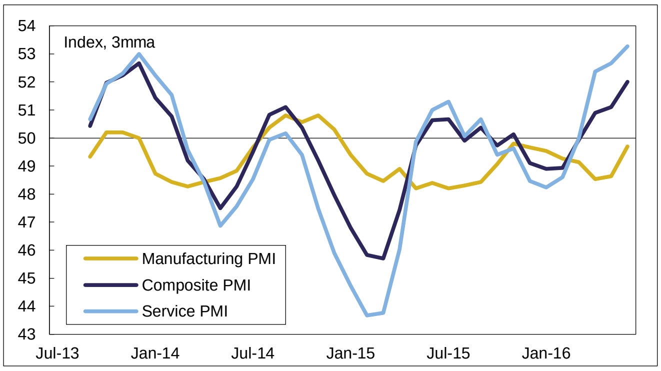
While the Reserve Fund in June fell to $38.2bn, down more than 50%Y/Y, the Wellbeing Fund decreased just 3.8%Y/Y to $72.8bn. The fiscal deficit for the first half of 2016 reached more than 4% of GDP, with budget revenues decreasing by 12%Y/Y according to Russian Minister of Finance Anton Siluanov. As the government expects the fiscal deficit for this year to be around 3.3% of GDP, and achievement of the target is going to require cuts to expenditure, we believe that further use of the Reserve Fund is inevitable (as the sanctions against Russia, which in reality render almost impossible borrowing abroad by most state-owned companies and even the government itself, were extended until January 2017). So, the probability of a significant decrease in the Reserve Fund by the end of the year is relatively high.

Inflation



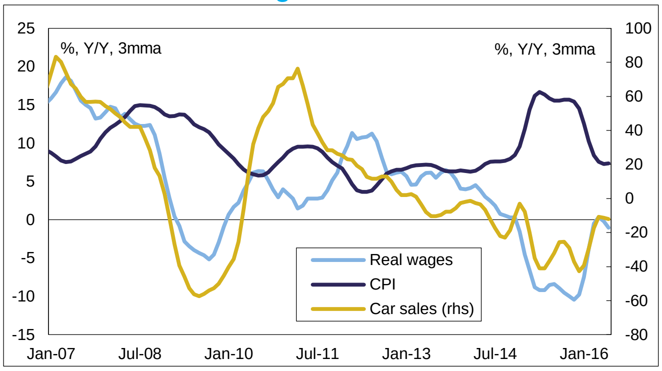
Source: Russia's Central Bank and Daiwa Capital Markets Europe Ltd.

PMIs



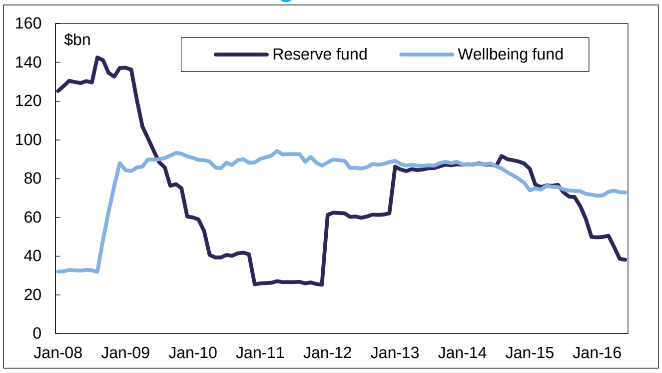
Source: Markit and Daiwa Capital Markets Europe Ltd.

Car sales and real wages



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Reserve and Wellbeing funds



Source: Ministry of Finance and Daiwa Capital Markets Europe Ltd.

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