



Russia

The recovery is taking shape

Russia's macroeconomic situation has consolidated. After a 2-year recession, the Russian economy swung back into growth in fourth-quarter 2016, inflationary pressures dropped sharply allowing the central bank to ease monetary policy, the rouble has appreciated significantly over the past twelve months, and the government launched a major programme to consolidate public finances. In the light of this new environment, the rating agency Standard & Poor's attached a positive outlook to Russia's sovereign rating, suggesting that it could soon be upgraded to "investment grade" if the country's macroeconomic situation continues to strengthen.

Exit from recession is confirmed

In fourth-quarter 2016, the Russian economy pulled out of recession as GDP rebounded by 0.3% year-on-year. For the full year, the economy contracted only 0.2%, after a 2.8% decline in 2015 (after revisions). Yet net exports were the only component that made a positive contribution to growth (1.5 percentage points), even though they slowed compared to 2015. For the second consecutive year, household consumption and investment declined, but at a much milder pace than in the previous year.

As to 2017, growth prospects are looking strong. Two factors are expected to fuel a rebound in economic activity: 1) the acceleration in household consumption, lifted by higher real revenues, and 2) an upturn in investment at a time of monetary easing. Given the sharp drop in inflationary pressures (prices rose only 4.5% yoy in March, down from 8% in the year-earlier period), the central bank managed to lower its key rates by 25 basis points (bp) in March, and is expected to continue along this path with a cumulative rate cut of 150 to 200bp over the full year to support growth.

Medium-term growth potential is still weak at 1%, or possibly 1.5%. Powerful structural constraints are still holding back the Russian economy¹. To counter these headwinds, President Poutine set up a programme co-directed by the finance ministry and Alexei Kudrin, the former finance minister, to establish a new medium to long-term development strategy to stimulate potential growth. Nonetheless, no large-scale reforms are likely to be launched before the next presidential elections in March 2018.

Public finances are less risky

A year ago, one of the biggest sources of concern was the country's public finances, even though total government debt including public administrations was less than 15% of GDP. It wasn't the size of the deficit that was alarming, but its financing. After international sanctions were set up, the government clearly had to dig into its reserve fund to finance a swelling budget deficit, made worse by the erosion of oil revenues. In two years, the reserve fund was down by nearly USD 72 bn (-82%).

Today, the situation is less alarming for several reasons: 1) oil prices have picked up, 2) the government has launched a fiscal austerity programme that aims to cut spending by 1 point of GDP annually, and to reduce the deficit to only 1% of GDP by 2019 (vs.

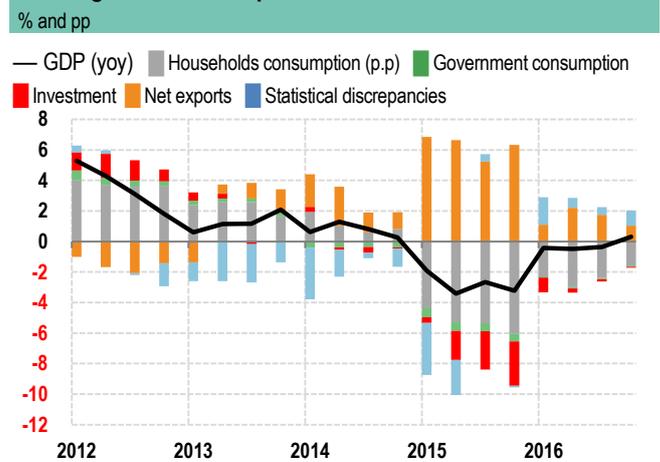
¹ The sub-optimal allocation of production factors, which is straining productivity, can be attributed to declining demographics, a heavy dependency on oil prices and the state's overly strong presence in the economy.

1- Forecasts

	2015	2016	2017e	2018e
Real GDP growth (%)	-2.8	-0.2	1.8	1.4
Inflation (CPI, year average, %)	15.5	7.1	4.9	4.5
General gov. balance / GDP (%)	-2.4	-3.7	-2.7	-2.1
Public debt / GDP (%)	13.6	14.3	15.6	15.2
Current account balance / GDP (%)	5.2	1.9	3.4	3.2
External debt / GDP (%)	38.9	38.1	32.2	30.6
International reserves (USD bn)	368	380	401	438
International reserves, in months of imports	11.9	13.3	12.9	12.9
Ex change rate RUB/USD (year end)	72.5	60.3	67.5	68.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- GDP growth and components



Source: Rosstat

3.4% of GDP in 2016), and 3) the finance ministry adopted a "temporary" law to transfer surplus oil revenues above USD 40 a barrel to the reserve fund. Adopted in February, this key measure should help rebuild the reserve fund sufficiently so that the government will not have to dip into the national wealth fund in 2017.

The reserve fund could increase by an estimated USD 18 bn in full-year 2017, assuming that oil prices average USD 52 a barrel. The finance minister also intends to finance more than 30% of the deficit by issuing debt, notably on domestic markets. He hopes to be able to take advantage of the increase in liquidity in the banking sector.

With the reserve fund depleted, in 2018 the government intends to tap into the national wealth fund, using about USD 17 bn (out of a



total of USD 73 bn) to finance 57% of the deficit. The remainder will be financed almost exclusively through debt issued in domestic markets. In 2019, nearly 89% of the deficit (estimated at 1.2% of GDP) will be financed in this manner.

The net external position is still solid

In full-year 2016, Russia reported a balance of payments surplus of about 0.7% of GDP, up 0.6 points of GDP compared to 2015. Although the current account surplus declined, foreign investment picked up and private capital outflows fell sharply (-67%).

In 2016, the current account surplus shrank to 1.9% of GDP, down from 5.1% of GDP in 2015. This decline is notably due to the 2.7 point decline in the trade surplus, reflecting the slowdown in exports in value terms.

At the same time, foreign direct investment (FDI) accelerated to 0.8% of GDP for the year (vs. -1.1% of GDP in 2015), reflecting the partial disposal of Rosneft, while portfolio investments increased significantly, to 0.2% of GDP. Moreover, loan payments by all private sector agents increased to 2% of GDP in 2016, which is 0.4 points more than in 2015.

For full-year 2016, net capital outflows slowed to only USD 13 bn, equivalent to 1% of GDP, compared to USD 70 bn the previous year.

Russia is still a net creditor in foreign currency, even though its position declined sharply in 2016. At year-end 2016, it came to USD 227 bn, equivalent to 17.6% of GDP, nearly 7 points less than the previous year. This 32% decline reflects the increase in the valuation of assets held by non-residents, and the privatisation of Rosneft.

Russia's external debt swelled to USD 513.5 bn at year-end 2016, equivalent to 39.7% of GDP, from 29% of GDP two years earlier. Yet the sharp increase in the debt-to-GDP ratio is not alarming because it reflects the decline in GDP in dollar terms (-37.8%), even though the level of debt contracted by 14.4%. After international sanctions were set up, private sector debt diminished by 15.7%. In 2016, the private sector continued to deleverage. In contrast, government debt increased after two sovereign debt issues to finance the fiscal deficit.

Debt payable within a year amounts to about USD 97.3 bn, of which USD 67.5 bn is for companies and USD 26.5 bn for banks.

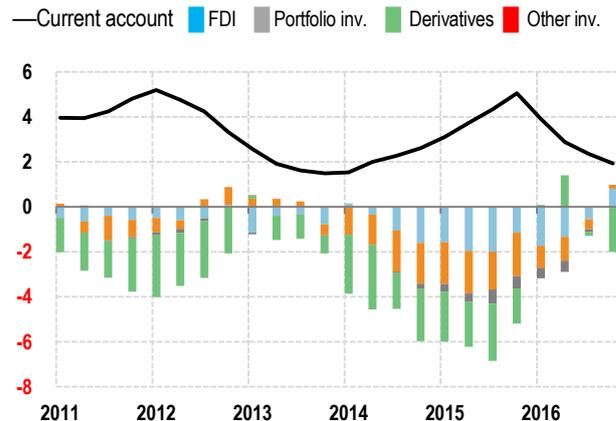
The outlook for the balance of payments is favourable. Since the second half of 2016, the terms of trade have improved and the current account surplus rose significantly in first-quarter 2017. Even assuming there is a net slowdown in capital inflows (no large-scale privatisation projects are in the works), private capital outflows should continue to decline in full-year 2017, in line with the decrease in debt repayments. Foreign reserves are expected to increase by more than USD 20 bn.

Banking sector consolidation is underway

The most recently available banking statistics show a slight improvement in the situation of the Russian banking sector in fourth-quarter 2016. The worst seems to be over.

According to IMF data, the non-performing loan ratio improved slightly compared to the two previous quarters, down 0.2% to 9.4%.

3- Balance of payments (4-quarter moving sum, % of GDP)



Source: Central Bank of Russia (CBR)

Non-performing loans are still concentrated in sectors turned exclusively towards the domestic market, such as construction and wholesale and retail sales. Loans that are more than 90 days overdue account for 24.7% and 13.4% of sector loans, respectively, which in turn accounted for 5.6% and 12.1% of total loans outstanding. In fourth-quarter 2016, business continued to contract in both sectors.

At the same time, solvency ratios have increased to 13.1% (9.2% for Tier 1 capital at the end of the year) and the financial performance of banks has improved. According to the central bank, ROA was 1.2% and ROE, 10.3%, in January 2017.

Johanna Melka
johanna.melka@bnpparibas.com