Russia

A stuttering and fragile recovery

Economic growth slowed in the third quarter and all the indicators suggest that this slowdown continued in the final quarter. The economy is still driven by domestic demand, whilst investment has stalled, despite more favourable monetary conditions. The sharp fall in inflationary pressures (reducing inflation below the central bank's target) has allowed the monetary authorities to cut policy interest rates by 225 basis points. The government continues to focus on the control of public spending in order to reduce its deficit and rebuild its sovereign wealth fund. It hopes to use this fund to uncouple its spending from oil revenue from 2019 onwards.

Slower growth in Q3 2017

Real GDP grew by 1.8% y/y in the third quarter, below the 2.5% posted in the second quarter. This took growth for the first three quarters of the year to 1.6%. Economic activity has been bolstered by the strength of domestic demand, whilst the contribution of net exports to growth remained negative, due in large part to high levels of imports of machinery and equipment. Russia is still not in a position to produce the capital goods it needs. Strong consumer spending explains the bulk of growth. It rose by 2.6% y/y, driven by the rise in real wages and a fall in the unemployment rate. Even so, despite an increase in pension payments, real disposable income continued to fall in 2017 even though inflationary pressures eased considerably. The other household income components (including those from the "informal" economy) fell indeed. GDP per capita (estimated at USD 10,250 in 2017) remains well below the pre-crisis level, a situation that the IMF expects to persist until 2022 at least. Investment slowed slightly in Q3 2017 reflecting, on the one hand, the government's desire to control public spending in a bid to reduce the deficit and, on the other, the result of lower investment in the mining sector.

Over the first three quarters of the year, the strongest sectors of the economy were non-tradable goods. Growth in manufacturing was only 0.7%, whilst it hit 3.8% in transport and 2.8% in wholesale and retail trade. Moreover, industrial production in October and November confirmed the deceleration of the economy in the final quarter, particularly in the transport equipment sector.

Over the next two years, growth is likely to continue to hover at around 1.7%. Household consumption will remain the main driving force. This will be favoured by lower inflationary pressures (2.5% y/y in December), the index-linking of civil service wages (from January 2018) and improved lending conditions (flowing from the 225 basis point cut in policy interest rates over the course of 2017). This said, structural constraints on the development of private investment continue to weigh on activity. Although the country's competitiveness has improved according to the latest World Bank Global Competitiveness report (Russia ranked 38th out of 137 countries), the business climate remains fairly hostile, in particular when it comes to quality of governance (166th of 211 countries).

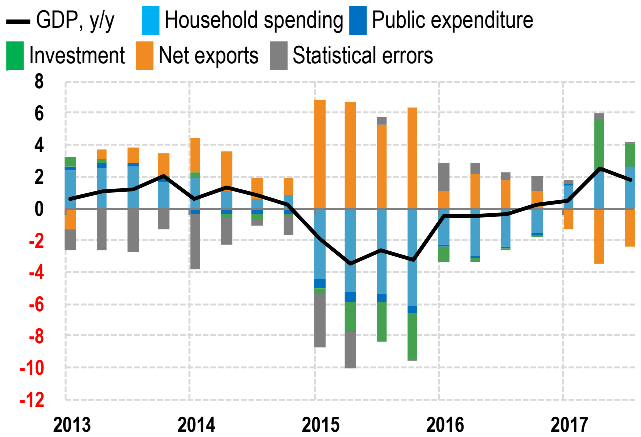
1- Forecasts

	2016	2017e	2018e	2019e
Real GDP growth (%)	-0.2	1.7	1.6	1.5
Inflation (CPI, year average, %)	7.0	3.7	4.0	4.4
General Gov. balance / GDP (%)	-3.7	-1.8	-1.0	-0.5
Public debt / GDP (%)	15.6	16.7	17.6	17.8
Current account balance / GDP (%)	1.9	2.6	3.0	3.5
External debt / GDP (%)	38.1	32.2	30.6	28.0
Foreign exchange reserves (USD bn)	318	356	395	430
Foreign exchange reserves, in months of im	11.2	10.9	11.2	11.3
Exchange rate USDRUB (year end)	60.3	57.7	60.0	61.0

e : BNP Paribas Group Economic Research estimates and forecasts

2- Slowing investment explains economic growth deceleration in Q3 2017

GDP in % and contribution to growth in percentage points



Source: RosStat

A new fiscal rule in 2019: reducing dependence on the oil price?

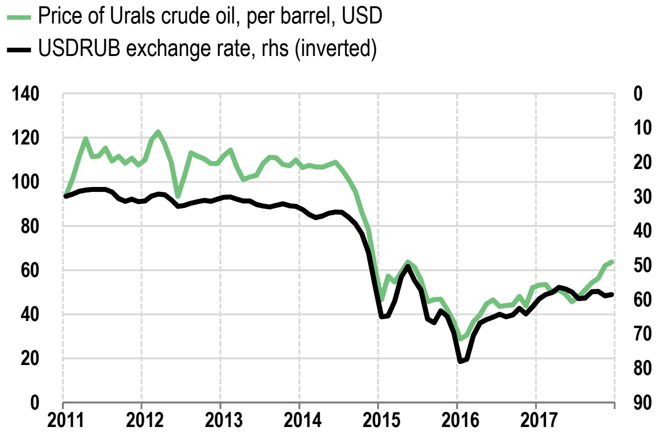
Russian public finances saw considerable consolidation in 2017. The government also hopes to reduce its dependence on oil revenues with the introduction of a new law in 2019. In order to achieve this it will first have to continue fiscal consolidation and reduce the deficit below 1% of GDP by 2019.

Over the first eleven months of the 2017 financial year, the federal government deficit was cut by more than 60% from its level a year earlier, to just 0.7% of GDP (from 2.4% in 2016). In addition, the primary balance was in surplus, of 0.1% of GDP, for the first time since 2014. These good results were due primarily to a sharp rise in revenue from oil and gas activities (up 22%), whilst growth in public spending remained controlled at 5.3%. The deficit excluding oil and gas revenue was down slightly on 2016, but nevertheless reached 8.1% of GDP. The government expects that for the full year 2017, the deficit will be 2.2% of GDP, from 3.7% in 2016.

It has two targets for 2018. First, cutting the budget deficit to 1.4% of GDP, and secondly rebuilding its sovereign wealth fund. This will allow it to introduce in 2019 a new fiscal law that will reduce the correlation between its expenditure and oil and gas revenue. Under the new fiscal rule, introduced from 2018, primary expenditure can not exceed the sum of expected revenue from oil and gas[1], revenue other than from oil and gas and debt servicing costs. This would limit expenditure to 17% of GDP (from 18.1% in 2017). In order to rebuild the sovereign wealth fund, the government will continue to apply in 2018 the 'fiscal rule' introduced in February 2017. All surplus revenue, generated by oil prices of over USD 40/barrel, will be used by the central bank, on behalf of the Ministry of Finance, to purchase foreign currencies, which will be transferred to the sovereign wealth fund (which will be merged with the reserve fund in February). Such measures have become all the more important given that the reserve fund was depleted by 31 December 2017. In 2017, this fiscal rule allowed a partial decorrelation of the rouble from the oil price[2]. The rouble rose by only 6%, against an oil price increase of nearly 18%. The Ministry of Finance estimates that currency purchasing in 2018 could reach USD34.6 billion if the price of Urals crude averages USD 54-55/barrel. This would be twice the level of currency buying seen in 2017. The national wealth fund would thus be boosted to nearly 6% of GDP by the end of 2018 (from 4% at 1 January 2018).

From 2019, a new fiscal rule will come into force. Expenditure will be decoupled from oil revenue. If oil prices fall below the base price set in the budget (USD 40/barrel adjusted for US inflation), the Ministry of Finance will draw on the sovereign wealth fund to finance the difference between projected and actual revenue. Thus expenditure will be protected from any fall in oil prices. However, if the value of the sovereign wealth fund is less than 5% of GDP, the amount used to finance expenditure may not exceed 1% of GDP.

3- Rouble exchange rate uncoupled from oil price in H2 2017



Source: CBR

Current account surplus rises in 2017

The balance of payments improved significantly in 2017. Despite substantial outflows of private capital, linked to the repayment of banking sector debt[3], foreign exchange reserves grew by nearly USD 40 billion, to USD 356 billion. This increase reflects currency purchasing by the central bank on behalf of the Ministry of Finance, and an increase in Foreign Direct Investment. Meanwhile, according to the central bank's initial estimates, in 2017 the current account surplus increased by 0.6 point of GDP to 2.6% of GDP. This improvement is a clear reflection of higher oil prices. Russia's balance of payments remains highly dependent on trends in commodity prices. Over the last ten years, there has been little change in the structure of Russian exports. In 2016, exports of commodities (both processed and unprocessed) represented nearly 75% of total exports, just 3 points less than ten years ago (despite the sharp fall in global commodity prices). This said, although commodity exports continue to dominate, Russia has managed to slightly increase its market share in medium- and high-tech sectors. Even so, high-tech products account for only 4% of exports. The transformation of the economy is taking its time.

Johanna Melka
johanna.melka@bnpparibas.com

[1] Projections were drawn up on the basis of a Urals crude price of USD 40/barrel (it was USD 53.1 on average over 2017) and a growth rate of 2.2%.

[2] Foreign currency purchases by the central bank are all the greater as oil prices climb above USD40/barrel. As a result, the higher the global oil price above the base level, the greater the downward pressure on the rouble.

[3] Outflows of private capital reached USD 31.2 billion in 2017, including USD 28.6 billion for the banks alone.