Russia

The risk of new sanctions puts pressure on the rouble

Despite the improvement in economic fundamentals (strong rise in the current account surplus, accelerating GDP growth and a fiscal surplus), the rouble depreciated by 13% against the dollar between April and September 2018. Tighter US sanctions in April and again in August 2018, combined with the threat of new sanctions this fall, triggered massive capital outflows. Despite a highly volatile rouble, bond and money market pressures have been mild. To counter the downside pressure on the currency, the Russian central bank raised its key rates in September, for the first time since 2014, and halted its foreign currency purchases on behalf of the finance ministry.

Growth accelerates in H1 2018

The economy grew 1.6% year-on-year (y/y) in the first half of 2018. Tighter US sanctions did not hamper activity, which was driven by dynamic domestic demand (bolstered by higher real revenues) and a rebound in the manufacturing industry. The upturn in manufacturing can be attributed to higher oil production quotas, but also to the increased output of machinery and capital goods, buoyed by dynamic investment and household consumption.

Although industrial output was still dynamic in July (+3.9% y/y), economic activity is expected to slow in the quarters ahead for several reasons including the rouble's depreciation, the VAT hike on 1 January 2019, higher interest rates and the risk of a further tightening of US sanctions.

In the longer term, raising the retirement age and a 6-year investment spending programme should help boost the potential growth rate.

Inflationary pressures are under control

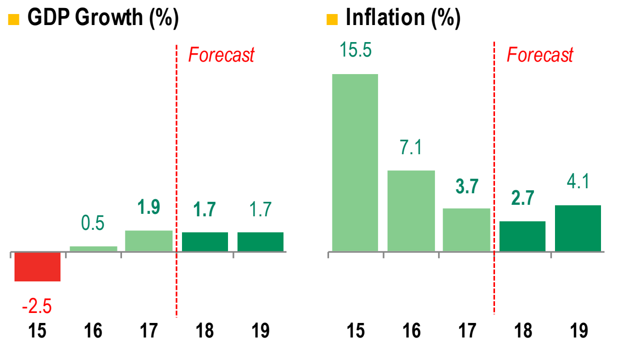
Price increases were mild in the first eight months of the year and averaged 2.4% y/y. Inflationary pressures have picked up slightly since June (+3.1% y/y in August), but are still lower than the central bank's inflation target of 4%, which it revised upwards in September. The economy is feeling the effects of the rouble's depreciation[1] while nearing full production capacity utilisation.

The VAT hike on 1 January 2019 is expected to lift prices by an additional 0.8 to 1.1 percentage points in 2019, assuming the rouble does not depreciate any further. The 2-point increase in the standard VAT rate applies to 66.1% of consumer goods. Moreover, the VAT rate will be raised from 10% to 20% for 25.7% of consumer goods.

To counter the rouble's high volatility and to dampen inflationary expectations, the central bank raised its key rates by 25 basis points (bp) at September's monetary policy committee meeting.

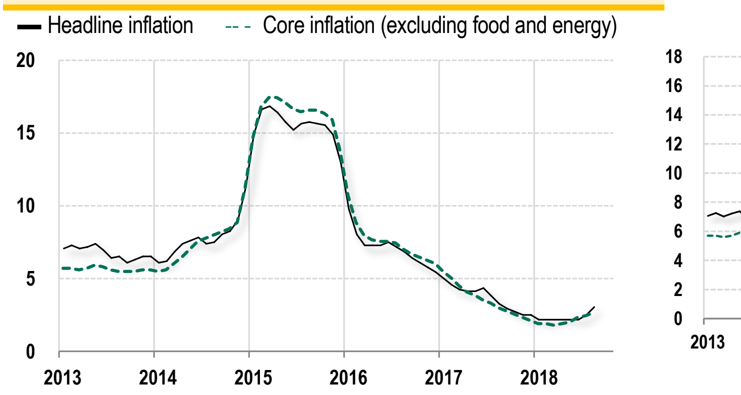
[1] The central bank estimates that a 10% decline in the nominal effective exchange rate generates a 1 percentage point increase in prices over a 3- to 6-month horizon.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Inflation is under control (y/y, %)



Source: CBR, BNP Paribas

A fiscal surplus and the rebuilding of sovereign fund in 2018

In the first 8 months of the year, the federal government reported a fiscal surplus of RUB 1830 bn, the equivalent of 3.1% of GDP, compared to a fiscal deficit of 0.7% of GDP in the year-earlier period.

After reporting a deficit for six consecutive years, the finance ministry is forecasting a full-year surplus of about 1.3% of GDP. The consolidation of public finances is mainly due to a big increase in fiscal revenues arising from oil & gas activities (+46.6%). Yet excluding oil & gas, the fiscal deficit still narrowed by more than 11% in the first 8 months of the year, thanks to the combination of higher non-oil & gas revenues (+15%) and tight control over public spending, which rose only 2.6% over the period. The non-oil-and-gas deficit was the smallest in six years.

At the same time, windfall revenues from oil and gas activities were funnelled into the National Wealth Fund (NWF). In the first 8 months of the year, the NWF increased by USD 10 bn to USD 75.8 bn. At the end of the year, we must also add in the USD 38 bn acquired by the central bank on behalf of the finance ministry.

For the next three fiscal years, the government has decided to pursue a less cautious and less conservative fiscal policy. Although it is forecasting fiscal surpluses of 1.8%, 1.1% and 0.8% of GDP, respectively, in 2019, 2020 and 2021, the government plans to increase the public spending to GDP ratio (+1.1 percentage points of GDP in 2019) for the first time since 2015.

The increase in public spending can be attributed notably to the social and economic development programme announced by president Putin last May. The equivalent of 7% of GDP (RUB 8 trillion) will be invested in the country's development between 2019 and 2024 to develop infrastructure, increase the level of education and boost healthcare spending. The government's goal is to raise the investment rate from 21.7% of GDP in 2017 to 25% of GDP by 2024. Yet even if the government manages to implement this programme, private investment will continue to be hampered by strong structural constraints.

The finance ministry does not intend to use the revenues generated by the VAT increase (estimated at 0.5% of GDP) to finance this social and economic development programme. Instead, it will be financed through domestic market bond issues each year for the equivalent of 0.5% of GDP.

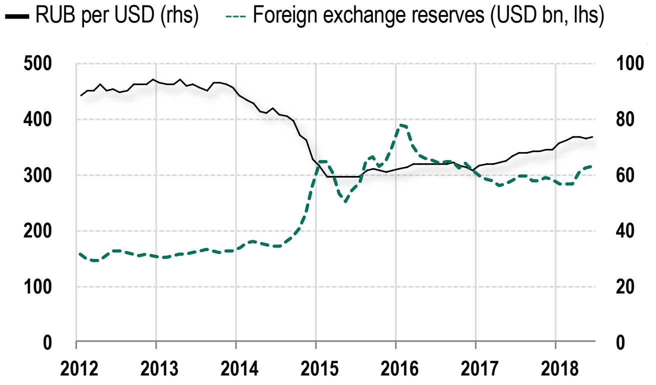
The rouble deteriorates sharply despite a higher current account surplus

In H1 2018, the current account surplus swelled to the equivalent of 6.7% of GDP, up from 3.3% of GDP in the year-earlier period. This improvement can be attributed to the strong increase in the trade surplus (+3.3 percentage points to 11.4% of GDP), thanks to the increase in oil and gas exports and to a lesser extent other types of exported goods.

Yet despite the improvement in macroeconomic fundamentals, Russia reported massive capital outflows following the tightening of US sanctions. The rouble depreciated by 13% against the dollar between April and September.

According to the balance of payments statement, sales of Russian assets by non-resident investors swelled to USD 17 bn in the second quarter. In comparison, this figure averaged more than USD 32 bn per quarter between Q3 2014 and Q1 2015. This movement continued in July and August. As a result, the share of sovereign debt held by non-resident investors declined by 7.9 percentage points between April and August to 26.6% on 1 September.

3- Downward pressures on the rouble



Source: CBR, BNP Paribas

The rouble's depreciation was accentuated by the central bank's foreign currency purchases on behalf of the finance ministry (to shore up the National Wealth Fund) for an amount equivalent to more than USD 24 bn between April and August. To counter the rouble's decline, the Russian authorities decided at the September monetary policy committee meeting to halt currency purchases on behalf of the finance ministry through the end of the year.

Despite the show of mistrust on the part of non-resident investors, pressures in the money and bond markets are still mild. Between April and September 2018, 10-year government bond yields rose only 100bp, deposit rates declined and the increase in 5-year CDS was limited to 25bp. Yet it could become harder to finance its USD-denominated debt if the US Congress were to approve two proposals, the Deter Act and the Daskaa Act. Both bills call for limiting the access of Russia's state-owned banks to the market for USD and to prohibit US investors from holding newly issued Russian bonds. Neither bill is very likely to be adopted because they are only supported by a minority of senators. This situation could change, however, after the US mid-term elections.

Yet Russia's foreign exchange reserves, which amounted to USD 373 bn at the end of August, largely cover the refinancing needs of the country's external debt, which are estimated at USD 79 bn by year-end 2019.

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