

Russia

2019: greater uncertainty

In 2018, Russia swung back into growth and a fiscal surplus, increased its current account surplus and created a defeasance structure to clean up the banking sector. The “new” Putin government affirmed its determination to boost the potential growth rate by raising the retirement age and launching a vast public spending programme for the next six years. Yet the economy faces increasing short-term risks. Monetary tightening and the 1 January VAT increase could hamper growth. There is also the risk of tighter US sanctions, which could place more downward pressure on the rouble.

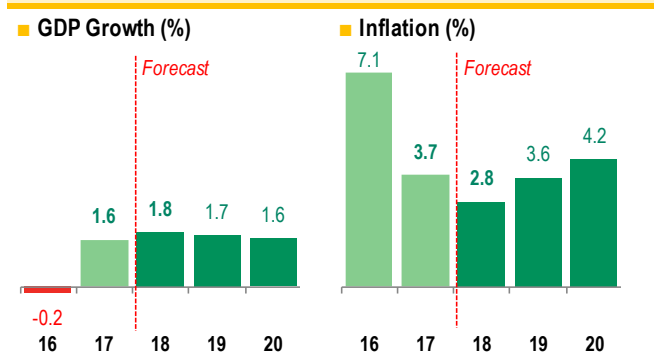
■ GDP growth slows in Q3

In Q3 2018, Russian GDP slowed to 1.5% year-on-year (y/y) from 1.9% the previous quarter. Growth averaged 1.6% in the first three quarters of 2018. Oil production rebounded by 5% thanks to a gradual increase in production quotas (+4% in the second half). In the agricultural sector, in contrast, activity contracted. Growth also slowed slightly in industry, but rose strongly in services. Leading indicators are still favourable for both the manufacturing and services sectors, but household consumption could be strained by the slowdown in employee purchasing power since August and the 1 January increase in the VAT rate, from 18% to 20%.

Since the beginning of H2-2018, inflation has accelerated to 3.8% y/y in November, compared to an average of 2.3% in the first six months of the year. For the moment, inflation is still lower than the monetary authorities' target of 4%. The upturn can be attributed to higher prices for food and non-food products as well as services. Three factors are driving inflation: unfavourable base effects (the 2017 harvest was particularly abundant, which helped lower food prices), higher gasoline prices, which carried over to transport costs, and the rouble's depreciation. From a 2-year horizon, growth prospects are still subdued and high risks loom over the economy. In December 2018, Russia agreed to reduce its oil output by 230,000 barrels a day (the equivalent of 2% of current production) starting in January 2019. The VAT hike and any second-round effects it might generate are likely to hamper domestic activity. So far, Russia's central bank is estimating that price inflation could range between 5% and 5.5% in full-year 2019, before falling back to 4% on average in 2020. Yet inflationary risk could be revised upwards if the US Congress decides to impose additional sanctions on Russia, which is likely to place more downward pressure on the rouble. To contain the risks of an inflationary spiral, the monetary authorities raised their key policy rate by 25 basis points to 7.75% last December and announced that further rate increases were now possible. Monetary policy tightening could strain investment, which has already begun to slow in the second quarter.

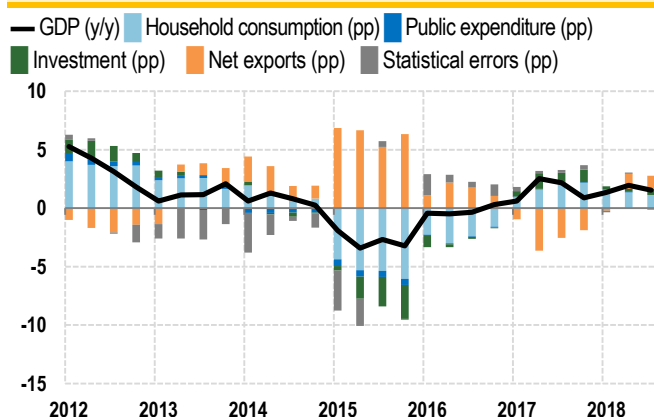
In the longer term, the World Bank estimates that Russia's potential growth rate will continue to erode from 1.5% in 2017 to 1.3% by 2022. Yet the institution esteems that this figure could be revised upwards to 3% if major reforms were implemented¹ to increase the active population (by raising the retirement age and adopting

1- Croissance et inflation



Source: National accounts, BNP Paribas

2- Economic slowdown in Q3-2018



Source: CEIC

policies that favour immigration) and to encourage the spread of technical advances.

■ Fiscal policy aims to stimulate growth

Russia significantly consolidated its public finances in the first 11 months of 2018, thanks to strong revenue growth and tight control over public spending. Yet the government temporarily abandoned its target of maintaining a primary balance over the next six fiscal years, and is now forecasting a primary deficit of 0.5% of GDP.

¹ Russia, Economic Report, November 2018



The government has pledged to increase structural spending to stimulate growth. This “budget overrun” should nonetheless be limited.

In the first 11 months of 2018, the federal government reported a fiscal surplus of 3.7% of GDP, compared to a deficit of 0.7% of GDP in the year-earlier period. The deficit excluding oil and gas revenues was trimmed to 4.9% of GDP, 1 point less than in 2017, thanks to the decline in the public spending to GDP ratio. The government and administrations reported a primary surplus of more than 3% in the first 10 months of the year.

The consolidation of public finances in 2018 should result in a reduction in the public debt to GDP ratio. With the increase in public spending as of 2019, this ratio is expected to rise steadily over the next six years.

In May 2018, the government announced several measures to reverse the country’s demographic dynamics, raise potential GDP, reduce poverty and extend life expectancy by 2024. To achieve this, the finance minister pledged to increase spending in numerous areas, including education, healthcare, infrastructure and support for SME. The cost of these measures was estimated at 1.1% of GDP per year over the next six years. The government plans to finance these measures in part by increasing the VAT rate (which will increase revenues by 0.5 to 0.6 points of GDP each year) and by streamlining oil sector taxation by 2024. The remainder will be financed by bonds issued in the domestic market. The increase in public debt is nonetheless expected to be limited to 5 points of GDP.

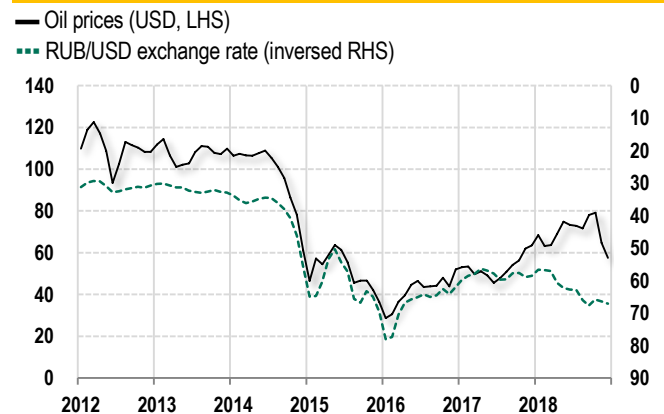
■ The banking sector is still fragile

The banking sector is still fragile due to its exposure to both credit risk and interest rate risk. Yet several factors should favour its consolidation, including government support, improved macroeconomic fundamentals and recent measures taken by the monetary authorities.

Over the past 12 months, the quality of bank assets has not improved even though companies are in a healthier financial situation since the rebound in economic activity (corporate loans account for 70% of all bank loans). According to the IMF, the share of doubtful loans in the banking sector as a whole has remained virtually flat at 10.7% in Q3 2018, compared to 10.2% at year-end 2017. In contrast, the share of lost or very doubtful loans² continued to rise according to the Central Bank of Russia, to 11.9% in October, from 10.5% at year-end 2017. The most fragile business sectors are construction and real estate, where the share of non-performing loans continued to rise over the past 12 months. Companies with foreign currency debt are likely to see their situation deteriorate even further with the rouble’s depreciation.

The strong acceleration in household lending over the past 12 months could also become a source of concern. Household lending rose 22.5% y/y in October (up from 10.7% a year earlier). So far, the decline in interest rates on household loans maturing in more than a year (down 165 bp in a year) have helped partially contain the

3- The rouble has been disconnected from oil prices since 2017



Source: CEIC

increase in the household debt burden. The ratio of household debt to revenue is on the rise since lending has increased faster than household revenue growth, but it is still very moderate at about 25%. To date, there has not been an increase in late payments on consumer credit or mortgage loans. To contain the risk, however, and to encourage banks to reduce their exposure to households, the central bank took measures in May and September 2018 to boost the weighting of consumer credit and mortgage loans (for those with small instalments) in the calculation of risk-weighted assets. At the end of October 2018, the banks had satisfactory capital adequacy ratios, with CAR and Tier 1 CAR of 12.4% and 9.5%, respectively, in October 2018.

Greater interest rate risk is another source of concern. According to the central bank, the banks’ exposure to interest rate risk has increased due to the growing mismatch in maturities between long-term assets and short-term liabilities. In October 2018, assets maturing in less than 1 year covered only 61% of liabilities of less than 1 year (vs 63% in January 2018).

Johanna Melka

johanna.melka@bnpparibas.com

² Categories IV and V. These statistics integrate the bad loans that were held by the state-owned banks recapitalised in 2017: Promsvyazbank, Otkritie, B&N.

