RUSSIA

BETTER ARMED TO HANDLE THE SHOCK

The Russian economy is more solid today than it was five years ago. After the 2014-15 crisis, the government managed to rebuild its sovereign wealth fund, which is now enabling it to offset the loss of oil revenue. Public finances are less dependent on oil revenues, thanks to the VAT increase in 2019, and the government should have no trouble meeting its short-term commitments. Yet lockdown restrictions and the collapse of commodity prices will have a big impact on both growth and the banking sector, which is still fragile, although it is less vulnerable to a forex shock.

THE ECONOMY IS EXPECTED TO CONTRACT SHARPLY IN Q2, BUT THE FIRST SIGNS OF A REBOUND APPEARED IN JUNE

Russia was hit by a double supply and demand shock in 2020, triggered by the lockdown of the population between 30 March and 11 May (and extended to mid-June in some districts), the collapse of Urals crude oil prices (-40% y/y in the first six months of the year), and the 20% decline in oil production since 1 May, in compliance with the OPEC+ agreement.

Real GDP growth was still 1.6% year-on-year (y/y) in Q1 2020, before plummeting by an average of 11% y/y in April-May according to the preliminary estimates of the Ministry of Economic Development. The downturn in industrial output accelerated in April and May, to -6.6% and -9.6%, respectively. All components of demand fell sharply. Retail sales were down 21% on average in April-May. The unemployment rate hit 6.2% in June, the highest level since the 2009 financial crisis, and real wages slumped (-2% in May). Similarly, in the first four months of the year, corporate profits plunged 54.4% y/y.

In June, economic activity should rebound slightly with the lifting of lockdown restrictions, as suggested by the latest survey results. In industry, the business confidence index rebounded to 49.4 in June after dropping to a low of 31.3 in April. Although the composite index is still below the 50 threshold that marks the beginning of expansion territory, industrial leaders expect activity to accelerate based on the increase in order books. Even so, for the full Q2, the Ministry of Economic Development is still forecasting a contraction in GDP of about 9.7% y/y.

In H2, economic activity should continue to strengthen, but the recovery will be slow and gradual. Several factors will boost the recovery, including an accommodating monetary policy (the Russian central bank has cut its key rate by 175bp since January), financial support for low-income households, a slight increase in public spending and mild inflationary pressures.

Consumer price inflation is expected to remain mild through the end of the year, holding below the central bank's target of 4% y/y. In June, inflation was 3.2% even though most of the rouble's depreciation last spring had probably carried over already to prices. This means the central bank has some manoeuvring room to cut its key rate below 4.5%, although any rate cuts are unlikely to exceed 50bp. At its June monetary policy committee meeting, the central bank made it clear that it did not want to see real interest rates drop into negative territory. Yet even with an especially accommodating monetary policy (key rates have never been so low before), it is hard to imagine a rebound in investment before 2021.

According to the central bank, GDP will contract between 4% and 6% in 2020, while the IMF foresees a decline of 6.6% followed by a big rebound in 2021.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	2.5	1.3	-4.2	3.5
Inflation (CPI, year average, %)	2.9	4.5	3.7	3.7
Central Gov. balance / GDP (%)	2.9	1.9	-4.8	-3.0
Public debt / GDP (%)	14.5	15.3	20.3	21.1
Current account balance / GDP (%)	6.8	3.8	0.1	1.2

TABLE 1
e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

INDUSTRIAL PRODUCTION

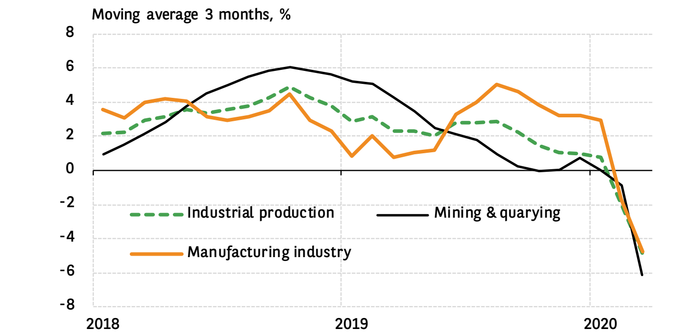

CHART 1
SOURCE: ROSSTAT

THE SOVEREIGN FUND OFFSETS THE DECLINE IN REVENUE

Since the 2015 crisis, the government and the central bank have worked to reduce the country's oil dependency. This mission has now been accomplished. In 2019, the equilibrium oil price was only USD 42 a barrel, down from USD 113 five years earlier. Moreover, in H1-2020, despite the collapse of oil and natural gas revenues (-35.4%), government revenues contracted by only 4.8%. In compliance with the fiscal rule in effect since 2017, the government used part of the national wealth fund's assets (USD 12.5 bn) to offset the loss of oil revenues, which fell below USD 42 a barrel between 11 March and 30

June 2020. At 1 June, the fund totalled USD 171 bn, or 10.7% of 2019 GDP. As a result, the government was able to maintain its spending commitments as part of the 2020 budget while accommodating the very sharp increase in healthcare spending arising from the coronavirus pandemic. In the first six months of the year, all spending increased by around 26%, generating an annualised deficit equivalent to 1.9% of 2019 GDP.

To counter the Covid-19 pandemic and the economic consequences of lockdown measures (notably for households and SME), the government announced three fiscal stimulus plans, which the World Bank estimated at a total cost of 2.8% of GDP. Moreover, on 2 June the Ministry of Finance announced a "recovery support package" valued at RUB 5000 bn (4.1% of GDP) to be implemented between Q3 2020 and Q4 2021. Yet this recovery plan includes the vast majority of previously announced support measures (notably the central bank's monetary measures to help SME). Additional spending is actually estimated at only RUB 430 bn (0.4% of GDP), about a third of which will be paid out in H2 2020, and the remainder as part of the 2021 budget.

In full-year 2020, the fiscal deficit is expected to near 5% of GDP, and public debt could slightly exceed 20% of GDP. Refinancing risk is extremely low for Russian debt, although some pressures have emerged in the bond market since June, after the Ministry of Finance announced bigger-than-expected domestic bond issues. Residents hold 67% of these bonds, and payments in 2020 and 2021 are estimated at USD 17 bn and USD 23 bn, respectively, of which only USD 4 bn is denominated in US dollars.

SOLID EXTERNAL ACCOUNTS

At 1 July, foreign reserves amounted to USD 438 bn, USD 5 bn less than at the beginning of the year. The rouble has lost only 9.1% in value against the US dollar since year-end 2019, even though Urals crude oil prices have fallen by more than 38% on average. The rouble's relatively strong showing can be attributed to the application of the fiscal rule of 2017: the national wealth fund sold off assets to offset fiscal losses, which helped boost the Russian currency. In the first six months of the year, the current account surplus shrank by 38% compared to the year-earlier period (to only USD 22.3 bn), even though the balance of services deficit narrowed after Russia closed its borders. The trade balance continues to show a surplus, even though it has fallen by more than 46% due to the downturn in oil exports.

In H2 2020, the easing of international travel restrictions, the expected rebound in merchandise imports, and a rebound in domestic demand will strain the current account, at a time when exports are likely to remain sluggish. In full-year 2020, the current account surplus is expected to narrow to about zero.

Increased portfolio investment should offset the downside pressures on the current account balance. Since May, non-resident investors have begun showing interest in Russian debt again, and issues are expected to reach RUB 5 tn (4.5% of GDP) over the full year. At 1 June, foreign investors held 31.8% of domestic debt (vs. 32.2% at the beginning of the year).

A MORE SOLID BANKING SECTOR THAN IN 2014

The banking sector is not as fragile as it was in 2014 and is in a better position to handle the upcoming crisis. Liquidity has increased, the banks have reduced debt (notably USD-denominated debt), and the sector has strengthened its external position. Although asset quality is still fragile, it has improved since 2018, and the degree of dollarization has been sharply reduced. In May 2020, doubtful loans still accounted for about 10.9% of loans outstanding, but debt restructuring (and any provisions) due to the Covid-19 crisis will not take effect until 30 September.

In the oil and metals sectors, companies seem to be in a sufficiently solid financial situation to absorb the decline in prices and demand. In contrast, the lockdown will have much bigger repercussions on companies in the transport, real estate, construction and tourism sectors.

The central bank expects to see a sharp increase in doubtful debt through early 2021. Default rates in these sectors could increase 2 to 3 fold, reaching 11-13% in hotel services, 9-10% in the production of non-essential goods, and 6-7% in real estate. Between 20 March and 6 May 2020, the banks restructured the equivalent of 3.7% of lending to large corporations and 6.9% of small business loans. Even so, the Russian banking sector should be able to handle the increase in credit risk. In April, the capital adequacy ratio was 12.7%. Moreover, the sector will continue to benefit from government support, although it could become more selective.

NATIONAL WEALTH FUND AND FOREIGN EXCHANGE RESERVES

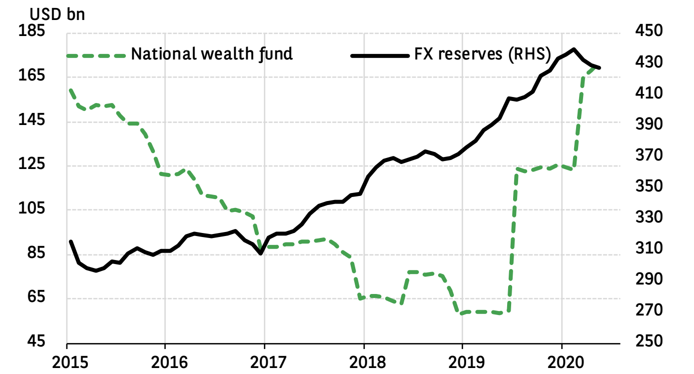

CHART 2 SOURCE: CBR

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