Russia

Economic growth faces headwinds

Economic growth slowed in the first months of 2019, and is now close to its potential growth rate of 1.5% according to the central bank. A 2-point VAT increase on 1 January has strained real wage growth and sapped household consumption. Inflation (5.2% year-on-year in February) is still below the central bank's expectations, and the key policy rate was maintained at 7.75% following the March meeting of the monetary policy committee. In the first two months of 2019, investors were attracted by high yields on Russian government bonds, despite the risk of further tightening of US sanctions. The rouble also gained 5% against the US dollar in Q1 2019.

Growth acceleration in 2018 is not what it seems

Economic growth accelerated to 2.3% in full-year 2018 from 1.6% in 2017. Yet this strong performance must be kept in perspective. The acceleration can be attributed primarily to a slowdown in imports, which reflects slowing investment as well as household consumption, albeit to a more limited extent. As a result, net exports made a very positive contribution to growth in 2018 (+0.8 percentage points) after a negative contribution in 2017. All other growth components slowed. The slowdown in investment growth (+0.2% y/y in Q4 2018 vs +4.5% in the first three quarters) was partially due to less favourable monetary conditions. Corporate lending rates rose slightly (+60 basis points) as monetary policy was tightened.

Faced, on the one hand, with downward pressure on the rouble due to the risk of tighter US sanctions and, on the other hand, with higher inflation expectations following the VAT increase on 1 January 2019, the Central Bank of Russia raised its key policy rate by 25 basis points on two occasions, in September and December 2018, to 7.75%.

Economic growth is expected to slow in 2019. In the first two months of the year, economic indicators point to slowing growth. Industrial output slowed to 2.3% in the first two months of the year from 2.7% in Q4 2018, according to central bank estimates. It is nonetheless resilient thanks to the increase in natural gas and metal output. In contrast, oil production continued to slow in compliance with OPEC agreements.

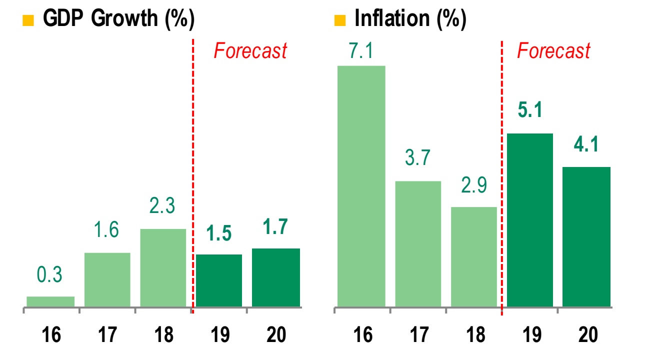
Production of capital goods and consumer goods (excluding food products) slowed in keeping with a net slowdown in retail sales and the drop-off in automobile sales. The slowdown in household consumption is mainly due to the 2-point increase in VAT, which has strained real wage growth (+0.7% year-on-year in February 2019, compared to a 2018 average of +7%).

Even so, confidence indicators in industry are still looking upbeat. Survey results suggest that domestic orders accelerated in March while export orders continued to sag. According to the Central Bank of Russia, economic growth is now close to its long-term potential rate of 1.5%.

Inflationary pressure rises

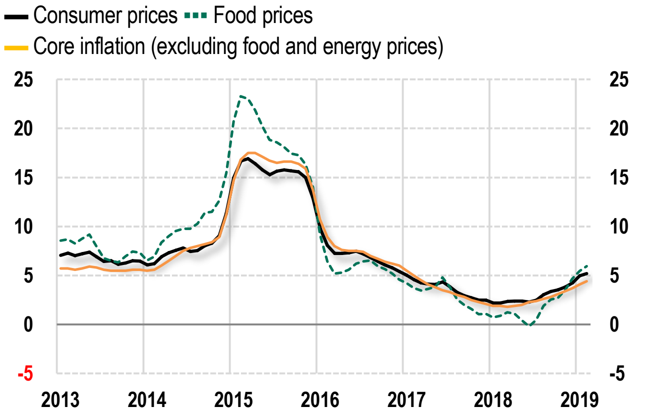
Consumer prices began to accelerate as of July, reflecting the rouble's depreciation, price increases for certain commodities (agricultural products and oil) and an unfavourable base effect

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Inflation (year-on-year, %)



Source : CBR

(notably for food prices). In December 2018, prices were up 4.3% year-on-year, compared to only 2.5% y/y in the year-earlier period. All products (food and non-food) were hit by this acceleration. Since the end of the year, price increases have accelerated (+1.2 percentage points to 5.2% year-on-year in February) due to the VAT increase, which accounted for nearly half of the recent price acceleration according to the central bank.

Non-resident investors return in first part of the year

In 2018, the current account surplus swelled to 6.9% of GDP, up from 2.1% of GDP in 2017. Buoyed by increases in international oil and gas prices, the trade surplus rose 4.5 points to 11.8% of GDP.

At the same time, imports declined slightly (-0.1% of GDP). The current account surplus covered the financial account deficit, which amounted to about 5% of GDP.

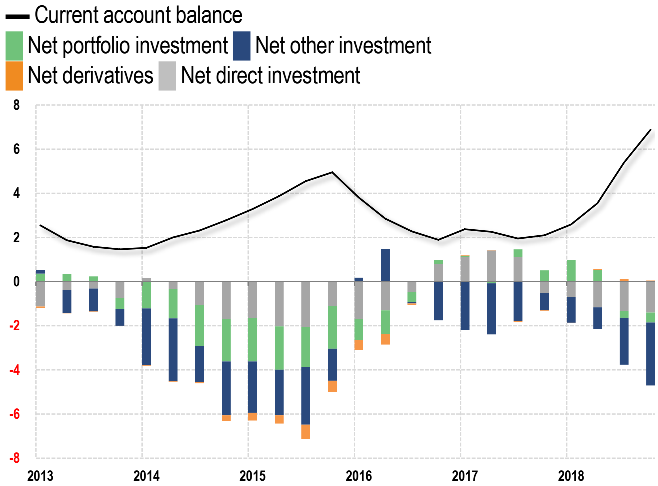
As a result, in full-year 2018, Russia's net external position increased by nearly USD 100 bn to the equivalent of 22.4% of GDP (compared with 17.3% the previous year). This change has reflected major capital outflows following the tightening of US sanctions in April 2018: stocks of foreign direct investment and portfolio investment declined by 6.2% and 9.5%, respectively. The improvement in the external position also reflects the contraction of loans (down 13%). Russia's external debt continued to decline in 2018 (by USD 64 bn) and shrank to only 27.4% of GDP (100% of exports) at year-end 2018, compared with more than 41% of GDP (157% of exports) in Q2 2016.
In the first two months of 2019, the current account surplus seems to have increased slightly due to the decline in imports, according to the central bank's preliminary estimates. Capital inflows accelerated despite the risk of tighter US sanctions. Government bonds held by non-resident investors increased for the second consecutive month, although they are still lower than in the previous year. In early March, non-resident investors held nearly 26% of government bonds issued in roubles. Non-resident investors were attracted by high yields on Russian government bonds at a time when interest rates are extremely low in Europe, and to a lesser extent, in the United States.

With the increase in oil prices since the beginning of the year and the decline in financial market pressures, the monetary authorities have begun purchasing foreign currencies again, which did not prevent the rouble from gaining 5% against the US dollar in Q1 2019. Foreign exchange reserves increased by USD 9 bn to more than USD 390 bn at the end of February, five times the amount of debt servicing from a 1-year horizon.

Risk of tighter US sanctions

In August 2018, Democrat and Republic senators Chris Van Hollen and Marco Rubio presented Congress with a bipartisan bill, Defending Elections from Threats by Establishing Redlines Act, also known as the Deter Act, which aims to sanction the Russian authorities suspected of US election interference in 2016. After the bill was rejected, the two senators submitted a new version on 3 April 2019 that was extremely similar to the previous one. The draft bill aims to sanction any country that influences US election results in any manner (based on the findings of an investigation by the Director of National Intelligence). If the law is adopted and Russia is found guilty of interference, US persons would be totally prohibited from purchasing Russian government bonds as well as bonds from companies owned or controlled by the Russian government. Sanctions would also be imposed on companies in the finance, energy and defence industries. Sberbank, VTB bank, Gazprombank, Vnesheconombank and Rosselkhozbank would be prohibited from making transactions with the United States. In the energy sector, any new investment by American entities would be prohibited. Lastly, any politicians or oligarchs implicated in US election interference would be prohibited from entering US soil and would be banned from making transactions with US persons.

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



Source : CBR

To date, there is strong dissension in Congress about the best measures to take against Russia, and President Trump is still opposed to them.

Even if legislation is adopted, over a 1-year horizon, it would not endanger the Russian government's external financing needs, which are estimated at a little under USD 80 bn.

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