RUSSIA

INFLATION AND GEOPOLITICAL RISKS WILL CONSTRAIN GROWTH

After showing rather strong resilience to the pandemic and the collapse of international oil prices in 2020, the Russian economy rebounded strongly in 2021. Yet two major risks are currently threatening growth: inflation and a tightening of international sanctions. These sanctions could even add to the inflationary risk. Nonetheless, the government has the financial capacity to support the economy, with solid public finances and low refinancing risks. Moreover, even if international sanctions were tightened to the point that foreign investors were denied access to Russia's secondary debt market, the government would still be able to finance itself on the domestic market.

INFLATION WILL HAMPER ECONOMIC GROWTH IN 2022

In the first three quarters of 2021, economic activity rebounded 4.6% compared with the same period in 2020. A very strong acceleration in domestic demand, especially household consumption, fuelled the recovery, while the contribution of net exports to growth remained negative due to a sharp upturn in imports. The big increase in domestic demand put major pressures on production capacity, and the capacity utilisation rate rose to more than 85% in Q3, an all-time high. This environment led companies to step up investment, especially in IT and services activities (banking, wholesale and retail). With the resurgence of the pandemic, activity seems to have slowed slightly in Q4 2021 but remained robust. In November, the unemployment rate hit a low of only 4.2%. Labour market pressures were particularly strong, generating higher wage pressure. In full-year 2021, economic growth may have reached 4.5%.

In 2022, growth prospects are not as favourable as in 2021, although they will still surpass the country's potential. Growth will automatically slow due to an unfavourable base effect. Although the Russian economy should benefit from high oil prices and production increases as part of its OPEC agreement, growth will be hampered by stubbornly high inflation, at least in the first quarter. In December, inflation rose to 8.4% year-on-year (y/y), while core inflation, excluding energy and food prices, rose to 8.9% y/y. These are the highest inflation rates since 2014-2015.

In the short term, inflationary risk will remain high in Russia for two reasons: 1) labour market pressures will persist, and 2) geopolitical risks will remain high, straining the rouble. In the monetary policy committee's latest report of December 2021, the Central Bank of Russia (CBR) estimated that inflation could drop back to its 4% target by the end of the year. Even so, the CBR could opt to raise its policy rates again as of the next monetary policy meeting in February, after raising them substantially in 2021, by a total of 425 basis points. Monetary tightening will weigh on corporate investment strategies. In Q3 2021, 24.4% of loans to small and mid-sized enterprises (SME) and 42.7% of loans to major corporates were variable-rate instruments.

PUBLIC FINANCES: STILL SOLID

In full-year 2021, the fiscal balance for all public administrations should have recorded a slight surplus, after reporting a deficit of 4% of GDP in 2020.

The consolidation of public finances can be attributed to a very strong increase in fiscal revenues, which rose more than 24% in the first 11 months of the year compared with 2019. Public finances mainly benefited from the big increase in oil prices and production: revenues from oil and gas-related activities accounted for more than 80% of federal government revenue, up from only 40% in 2019. Fiscal revenues also benefited from the dynamic momentum of household consumption and the increase in corporate profits. As to spending, the government reduced its expenditures by nearly 5% compared to the same period in 2020, although they were still much higher than pre-Covid-19 levels.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	2.0	-3.0	4.5	3.0	1.8
Inflation (CPI, year average, %)	4.5	3.4	6.7	6.3	4.1
Central Gov. balance / GDP (%)	1.9	-4.0	0.2	1.1	0.5
Public debt / GDP (%)	13.8	19.3	18.0	16.2	15.0
Current account balance / GDP (%)	3.8	2.3	6.0	5.0	3.2
External debt / GDP (%)	28.5	31.6	30.8	29.2	29.0
Forex reserves (USD bn)	425	445	462	485	499
Forex reserves, in months of imports	15.1	17.6	17.5	16.5	16.2

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ACTIVITY INDICATORS

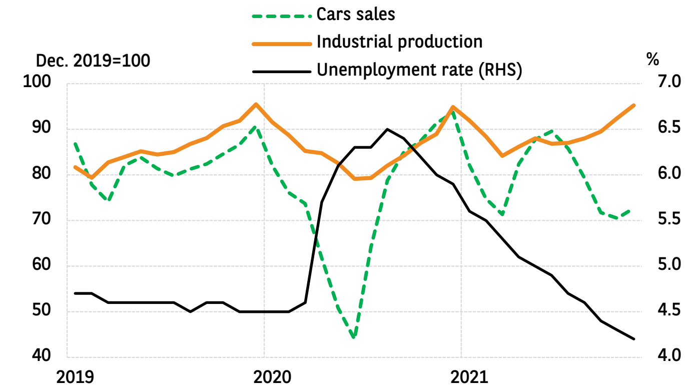

CHART 1

SOURCE: ROSSTAT, BNP PARIBAS

The consolidation of public finances is expected to continue in 2022 and 2023. Over the next two years, the government is forecasting *surpluses* of 1% and 0.2% of GDP, respectively. In 2024, it is calling for a deficit of only 0.3% of GDP, which should be financed by bond issues in the domestic market.

Excluding a decline in oil prices, the main short-term risk is a stronger-than-expected increase in inflation, since 42% of the Russian population is highly dependent on government subsidies. According to the rating agency Moody's, every 1 percentage point increase in inflation could result in an increase in public spending of 0.2% of GDP.

In case of a shock, however, the government has comfortable fiscal manoeuvring room to support the economy. In 2021, solid public finances and the dynamic momentum of nominal GDP growth should help reduce the public debt to only 18% of GDP (vs. 19.3% of GDP in 2020).

Moreover, the asset value of the National Wealth Fund is very comfortable. The government can use the fund not only to finance its development projects, but also to face up to any oil price shocks, as was the case in 2020. At 1 December 2021, the fund was valued at USD 185 bn, the equivalent of 12% of GDP. In 2022, the fund's value should increase by more than USD 41 bn (2.5% of GDP). This amount corresponds to the central bank's FX purchases on behalf of the finance ministry in 2021, in compliance with the fiscal rule that stipulates that the government must save any surplus oil revenues once oil prices exceed USD 40 a barrel.

Another risk that cannot be neglected is a tightening of international sanctions. They would not only drive up the cost of financing for the government, but also would force it to finance itself solely on the domestic market. Yet the government's financing needs are small over a 3-year horizon. For the period 2022-2024, bonds reaching maturity are equivalent to only 2.8% of GDP, and most are comprised of domestic bonds (Eurobonds maturing in 2022 and 2023 amount to USD 5 bn, or 0.3% of GDP). The share of debt held by non-resident investors is also small (less than 14% of total debt). There are sufficient domestic savings to face up to any new sanctions that would restrict non-resident investors from purchasing public debt in the secondary market. At end-November 2021, non-residents held 20.5% of domestic bonds. The government and the CBR are also seeking to reduce their dollar dependency. The finance ministry issued more euro-denominated Eurobonds, and the CBR reduced the share of foreign reserves held in dollars (to only 16.4% in Q2 2021, down from 22.2% a year earlier).

BANKING SECTOR: STRONG RESILIENCE TO THE CRISIS

*T*he banking sector showed strong resilience to the Covid-19 crisis. Profitability rose, capital adequacy ratios remained satisfactory and the quality of assets, though fragile, improved slightly.

Bank profits rose by more than 20% in the first 11 months of 2021 compared with the same period in 2019. In Q3 2021, the return on assets (ROA) and the return on equity (ROE) were 2.2% and 21.5%, respectively, compared with the pre-crisis levels of 1.6% and 18.6%. This strong performance was mainly due to the decline in excessive provisions.

After enjoying greater flexibility during the Covid-19 crisis, banks have had to report all of their non-performing loans as of 1 July 2021. Even so, it was still possible to restructure loans held by the most vulnerable households and SMEs. At the end of September 2021, the CBR estimated that since March 2020, loan restructuring had involved 15.2% of loans to large companies, 14.4% of loans to SMEs and 4.2% of household loans.

INFLATION

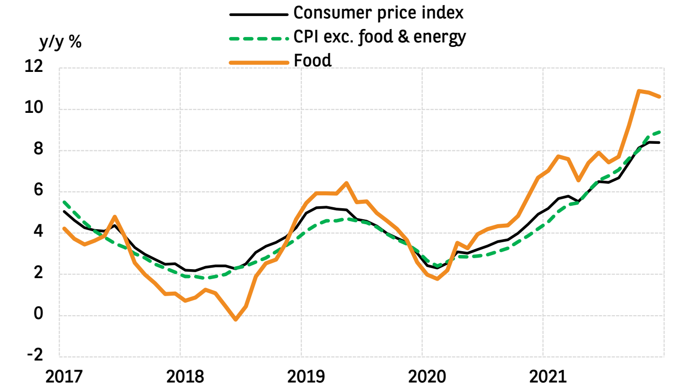

CHART 2

SOURCE: CBR, BNP PARIBAS

The CBR also estimates that between 20% and 30% of these restructured loans could default.

Yet the latest figures reported by banks are encouraging. Asset quality has not deteriorated thanks to support measures adopted by the government and the central bank. At the end of November 2021, risky assets accounted for 16.8% of total loans outstanding, which is 0.8 pp below the pre-pandemic level. According to IMF estimates, the share of non-performing loans declined from 10% at year-end 2019 to 7.5% in Q3 2021.

All in all, the capital adequacy ratios are acceptable. CAR averaged 12.4% in Q3 2021, which is higher than the regulatory requirement of 9%.

The degree of dollarization also declined slightly. The share of deposits and bank loans denominated in foreign currencies amounted to 23.5% and 15.4%, respectively, in October 2021.

The slight improvement in the quality of bank assets can be attributed in part to the consolidation of corporate balance sheets.

At year-end 2021, corporate debt was still contained (41.4% of GDP in November 2021) and the EBITDA-to-interest coverage ratio was 6.8x.

In contrast, the financial situation of households continued to deteriorate in keeping with the increase in their debt burden (+4pp since the outbreak of the crisis, despite the authorities' attempts to curb household lending). Though still limited, household debt came to 20.9% of GDP in November 2021. In Q2 2021, the CBR estimated that loan repayments would account for 10.2% of disposable income on average, which is unprecedentedly high. Although most household loans are comprised of mortgage loans, the risks are higher for unsecured loans, whose value per borrower has increased *according to the CBR.*

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