Russia

Resilience but no growth

In August, the rating agency Fitch upgraded Russia's sovereign rating based on its greater resilience to the external environment. The timing might seem surprising considering that Russian GDP growth slowed sharply in H1 2019 and the central bank had to revise its outlook for 2019-2021 downwards again. Even so, the consolidation of Russian fundamentals is undeniable. Currently the main sources of concern are the sharp increase in household lending and the delays in implementing public spending programmes, which should stimulate growth in the medium term.

Economic growth slowed sharply in H1 2019

In first-half 2019, GDP growth slowed sharply to 0.7% year-on-year (y/y), compared to 2% in H1 2018. This slowdown can be attributed to the decline in domestic and foreign demand. Exports contracted due to the decline in global demand and the adoption of new oil output quotas as part of the OPEC agreements. Household consumption slowed sharply following a 2-point increase in the VAT rate as of 1 January. Investment also slowed. Public investment projects announced for 2019 were postponed, and by August they still had not been implemented. Moreover, the monetary environment is not favourable for an upturn in private investment, although the decline in interest rates since June should reverse this trend.

The Central Bank of Russia (CBR) proceeded with three 25bp rate cuts between June and September. Monetary easing was facilitated by price inflation that was not quite as high as the monetary authorities expected, and close to the target rate of 4% (prices rose 4.3% y/y in August). By the end of July, more than 80% of this monetary easing had carried over to corporate lending rates.

Even so, growth prospects are still sluggish. The central bank has revised its outlook for 2019, 2020 and 2021 downwards again. Growth is only expected to accelerate by 2% to 3% in 2022 if the government manages to remove some of the structural impediments to growth (notably by increasing expenditure on education, healthcare and infrastructure as planned in the national spending programme of May 2018).

Banking sector: increase in household loans is a new source of risk

The banking sector continues to consolidate but the economic slowdown could undermine the quality of assets. The sharp increase in household lending is a new source of risk, even though the central bank tightened its prudential regulations again on 1 October.

The monetary authorities have continued to clean up the banking system over the past twelve months. In September 2019, there were 454 banks, down from 1,344 in 2000.

The quality of bank assets has also improved since mid-2018, even though it is still fragile. In July 2019, the doubtful loan ratio was 9.9% of all loans, while the share of risky assets (non-performing and restructured loans) declined to 17.9%, from 19.1% the previous year. This consolidation reflects the deleveraging of non-financial companies on the one hand, and on the other, the transfer of the risky assets of three private banks (Otkritie, B&N and Promsvyazbank) to Trust Bank, a defeasance structure, as part of the rescue package set up by the central bank. At the same time, the capital adequacy ratio improved slightly to 12.3% in July.

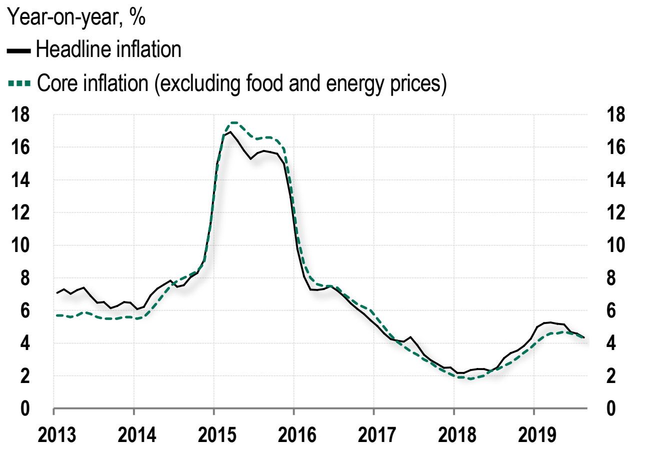
The dollarization of the banking sector continued to decline. In July 2019, 20% of loans and 25% of deposits were denominated in foreign currencies, compared to 35% and 42%, respectively, in 2015. Moreover, at the end of March 2019, the external position of all

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.6	2.3	0.9	1.5
Inflation (CPI, year average, %)	3.7	2.9	4.7	3.8
Central Gov. balance / GDP (%)	-1.5	2.9	1.7	1.0
Public debt / GDP (%)	15.5	14.3	14.8	15.1
Current account balance / GDP (%)	2.1	6.9	5.3	3.0
External debt / GDP (%)	32.8	27.2	26.6	23.8
Forex reserves (USD bn)	356	375	424	440
Forex reserves, in months of imports	10.3	12.8	13.0	13.2
Exchange rate USDRUB (year end)	58.3	69.4	67.0	66.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Price inflation is close to target



Sources: CBR, CEIC

banks was still largely positive, with external assets covering 1.5 times external commitments. The external debt of banks was down by 61.5% compared to 2014 and accounted for only 4.9% of GDP in Q2 2019. Payments due by March 2020 were limited to USD 18.1 bn.

The banking sector's profitability has picked up with a 50% y/y increase in profits in August 2019. The return on equity (ROE) and assets (ROA) were 17.3% and 1.9%, respectively, in July 2019 (compared to 6.8% and 0.8%, respectively, in the year-earlier period).

Although the banking sector is generally more solid than it was a year ago, the sharp increase in household loans is a new source of concern. Up 21.9% y/y in July 2019, household loans grew at a much faster pace than wage growth (+9% y/y). Moreover, interest rates on household loans are still high (13% on loans maturing in more than one year in July 2019). Contrary to corporate rates, they have only declined by 17bp since the beginning of the year.

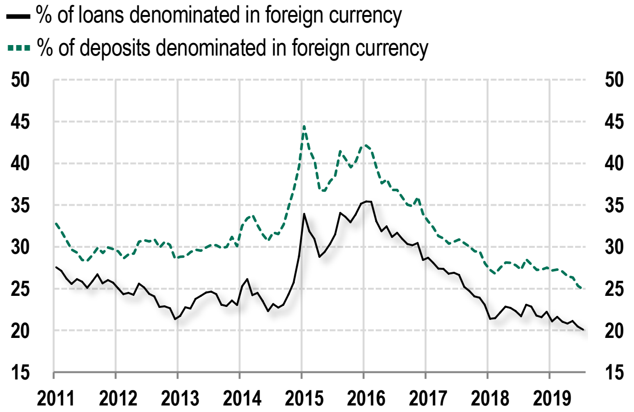
So far, household debt has only increased by 3 percentage points to 16.3% of GDP in Q2 2019. According to the central bank, the debt ratio is still moderate at 25% of revenues at end-2018. Household loans as a share of bank portfolios is also moderate (26% of total loans) and the doubtful loan ratio was limited to 5% at the end of July. The situation nonetheless needs to be watched, especially for loans without collateral (50.4% of household loans), which have a doubtful loan ratio of 8.4%. To encourage banks to reduce this type of household lending, the central bank has increased the weighting of loans without collateral in the calculation of risky assets on four occasions since 1 March 2017. Moreover, as of 1 October 2019, a new weighting will be introduced for loans whose debt servicing exceeds 50% of revenue.

US Congress tightens sanctions

On 2 August 2019, the US government adopted new sanctions against Russia in application of the 1991 Chemical and Biological Weapons Control and Warfare Elimination Act, but they are unlikely to have much of an impact. The main measure forbids American banks from participating in foreign currency bond issues by the Russian government and to grant foreign currency loans to any Russian public organisation. The new sanctions do not cover local currency government bonds (OFZ) and do not prevent American banks from purchasing foreign currency bonds in the secondary market.

In September 2019, the stock of Eurobonds held by foreign investors amounted to only USD 22.5 bn (11.5% of Russian bonds, i.e. 1.4% of GDP) and all external public debt amounted to only USD 49 bn, the equivalent of 11.7% of foreign exchange reserves. Moreover, in full-year 2019, the government only issued USD 5.5 bn and EUR 750 m in Eurobonds. It had no trouble placing the bonds at high yields (5.1% for USD bonds maturing in 2035). Even if new sanctions were implemented against the Russian state, the government still has the capacity to face up to the situation given its low debt level (14.6% of GDP) and mild financing needs (equivalent to an annual average of 0.8% of GDP over the next 5 years).

3 – The dollarization of the banking sector has declined



Source: CBR

External vulnerability declines

Russia has consolidated its external position through the accumulation of foreign reserves (USD 423.1 bn at the end of September 2019, a USD 39 bn increase from the previous year), the decline in the external debt (29.5% of GDP in Q2 2019 vs. 41% in 2016) and the partial uncoupling of oil prices and the rouble's exchange rate. The external position amounted to USD 370 bn in Q1 2019, the equivalent of 22% of GDP.

Debt payments due over the next twelve months, estimated at USD 50 bn by the central bank, should be covered by the current account surplus, which reached an annualised rate of USD 91 bn in H1 2019. It is expected to remain solid, even though it has declined somewhat compared to 2018.

Foreign exchange reserves should continue to swell, buoyed by the current account surplus on the one hand and by the central bank's foreign currency purchases on behalf of the ministry of finance on the other. In the first 8 months of the year, they amounted to USD 32.8 bn.

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