RISKS UNDER CONTROL DESPITE THE LATEST COVID WAVE

After a modest contraction in 2020, the Russian economy has registered a solid growth rebound since March 2021 driven by the strength of domestic demand and exports. The third wave of the epidemic seen since June, alongside strong inflationary pressure and the resulting tightening of monetary policy, could, however, hold back the recovery. This said, the threats to the economy remain under control. Public finances have been boosted by a sharp rise in global oil prices and the debt refinancing risk is limited despite the latest US sanctions. Lastly, foreign exchange reserves cover the totality of external debt.

MARKED ECONOMIC RECOVERY SINCE MARCH

In 2020, despite particularly unfavourable circumstances (falling commodity prices and lower oil production under OPEC+ agreements), the economy contracted by only 3%. However, the recovery has been more gradual than in several other emerging economies. In the first quarter of 2021, real GDP had still not returned to its end-2019 level.

Since March, economic growth has accelerated significantly, driven by the strength of exports, substantial government expenditures and increased business and consumer confidence. In May, due mainly to the basis of comparison, growth hit 10.9% y/y according to the Ministry of Economic Development and indicators of economic activity in May are very encouraging. Household consumption has remained solid, helped by a drop in the unemployment rate (to 4.9% in May), even though this is still slightly higher than before the crisis. Meanwhile, corporate profits have continued to rise, particularly in the manufacturing and mining sectors, but also in wholesale and retail. Business failures have dropped to a level not seen since 2015. However, capacity utilisation rates remain modest (60% over the first five months of 2021, compared to 64% before the Covid-19 crisis).

At the June meeting of its monetary policy council, the Central Bank of Russia (CBR) estimated that the Russian economy could regain its pre-Covid level as from the second quarter of 2021.

Nevertheless, two threats remain in the second part of 2021: a third wave of the pandemic and a sharp rise in inflationary pressures.

Since the beginning of June, the number of new Covid-19 cases has risen sharply. At the end of June, restrictions due to the health situation remained modest. The government has not introduced a national lockdown, but restrictions at regional level have been introduced, forbidding non-essential activities for anyone considered not to be immunised against the virus. Meanwhile, the government has put increased pressure on citizens to get vaccinated. Public sector employees and those working in personal services must be vaccinated or risk losing their job. By the end of June, less than 12% of the population had been fully vaccinated.

Inflationary pressure represents the second factor that could undermine the recovery. Inflation hit 6% y/y in May (from 5.2% at the beginning of the year). This acceleration reflects the rapid rise in the price of food (due in particular to the rise in global cereal prices) and energy, but other factors also came into play. Indeed, inflation excluding food and energy also hit 6% y/y in May. According to the CBR, price increases are due in part to accelerating domestic demand, which encouraged companies to pass higher production costs on to clients in selling prices. Consumer inflation expectations also remain very high, albeit slightly lower in May than in April while real disposable income fell by 3.6% in Q1 2021.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	2.0	-3.0	4.0	2.5
Inflation (CPI, year average, %)	4.5	3.4	5.8	4.3
Central Gov. balance / GDP (%)	1.9	-3.9	-1.5	-0.7
Public debt / GDP (%)	13.8	19.3	18.5	18.0
Current account balance / GDP (%)	3.8	2.3	3.0	2.4
External debt / GDP (%)	28.5	31.6	31.0	28.5
Forex reserves (USD bn)	444	457	470	482
Forex reserves, in months of imports	15.1	17.6	17.5	16.5

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ECONOMIC INDICATORS

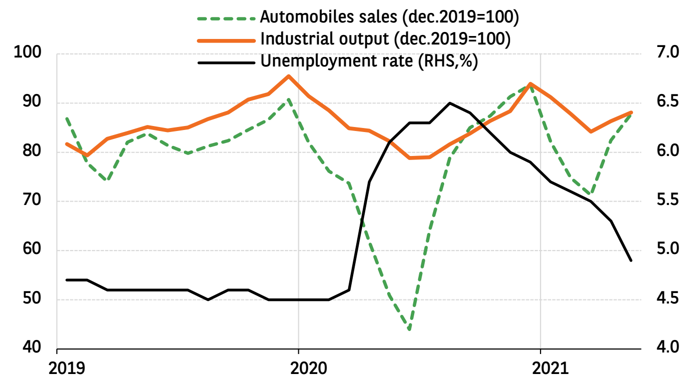

CHART 1

SOURCE: ROSSTAT

In an attempt to contain these inflationary pressures, the CBR raised its policy rates by 50bp at the latest meeting of its monetary policy committee, taking them to 5.5%, with further increases expected before the end of this year.

CONSOLIDATION OF PUBLIC FINANCES OVER THE FIRST FIVE MONTHS OF 2021

Despite being weakened somewhat by the Covid-19 crisis, the public finances remained solid in 2020. In 2021, the government plans to reduce the deficit from 3.8% of GDP to 2.3%, with debt rising slightly to 20.4%

of GDP. However, these forecasts could be revised downwards given the performance over the early part of 2021. Apart from anything else, the government's figures are based on very conservative assumptions for the oil price (USD 43.5 per barrel of Urals crude, against an average actual price of USD 61.6 between January and May 2021).

Over the first five months of the year, public finances were consolidated relative to the same period last year. This brought a very slender budget surplus despite a steep rise in public spending (up 10.3% y/y). Spending had already reached 42% of the full-year target (compared to an average of 37% over the past five years). The biggest increases have come in infrastructure spending and, to a lesser extent, debt interest payments, even though these remain extremely modest at 4.5% of revenue.

Over the same period, government revenue has increased by more than 18%, reaching nearly 50% of the full year target, due primarily to a very strong increase in revenue on oil and gas activities (28.4%) in line with the increase in global oil prices (the price of a barrel of Urals crude price denominated in rouble has increased by nearly 35% since the end of 2020) and the volumes exported. Non-oil and gas revenue also grew strongly, putting it 13.4% ahead of the same period last year.

Over the whole of 2021, the government plans to finance its deficit solely through issuing rouble-denominated debt on the domestic market. The implementation of the latest set of US sanctions, preventing US investors from buying Russian government debt on the primary market, took effect on 9 June. But this will not damage the government's ability to issue debt; issuance has remained fully subscribed by investors since this date. This said, since the announcement of these new sanctions, the share of domestic bonds held by foreign investors has fallen sharply; it stood at only 19.5% at the end of May, from 31.8% a year ago.

The government's debt refinancing risk is considered to be low. The debt profile is favourable (63% of debt is held by residents and 76% is denominated in roubles), and the National Wealth Fund will cover all of the government's financing requirements over the next two years.

EXTERNAL ACCOUNTS ALSO REMAIN STRONG

In 2020, Russia's external accounts remained solid, despite the 1.5 percentage point fall in the current account surplus (to 2.3% of GDP) and significant capital outflows from both resident and non-resident investors (net portfolio investment recorded a deficit of 1.7% of GDP over the full year). Foreign direct investment (excluding reinvestment), which was already structurally low, also dropped by nearly 68% over the year as a whole, taking it to less than 0.6% of GDP.

Faced with this pressure on external accounts, the central bank has allowed the rouble to float more freely in order to protect its foreign exchange reserves, despite the fact that it has sold currency on behalf of the finance ministry since March 2020 (in accordance with the fiscal rule of February 2017[1]). Over the full year, the rouble lost 15% against the US dollar, but foreign exchange reserves were consolidated.

Since January 2021, in line with the rise in international oil prices, the current account surplus has significantly increased, gaining 24.7% over the first five months of 2021. Meanwhile, private capital outflows, whilst smaller than in the same period last year, remained significant in the first quarter of 2021 (USD 11.8 billion), but they resulted mainly from banks' debt repayment.

INFLATION

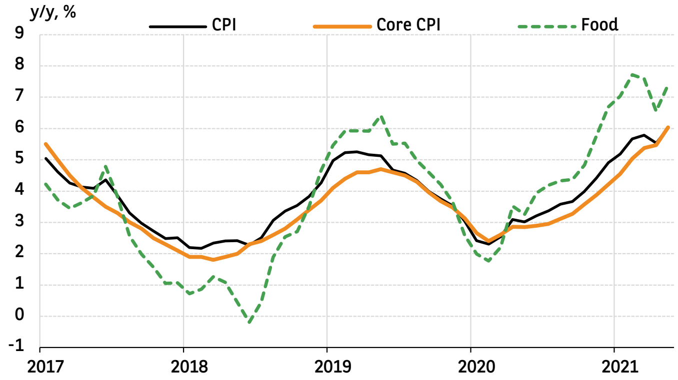

CHART 2

SOURCE: CBR

At the same time, forex purchases by the central bank resumed: they reached more than USD10 billion in the first half of 2021 (compared to net sales of USD 20 billion in 2020), thus limiting the appreciation in the rouble against the US dollar to just 2.7% over the first six months of the year.

In May 2021, foreign exchange reserves stood at USD 465 billion, covering 17 months of imports and the country's entire external debt (USD 459 billion in March 2021).

Russia remains highly exposed to the volatility in commodity prices and vulnerable to an increase in risk aversion amongst foreign investors, caused notably by the tightening of US sanctions (portfolio investment by non-residents, though lower, was still 17.3% of GDP at the end of 2020). The CBR has demonstrated its ability to manage tensions in external liquidity, but the use of the rouble as a variable of adjustment comes at the risk of creating inflationary pressures.

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Johanna MELKA
johanna.melka@bnpparibas.com

1 The 2017 fiscal rule aims to reduce the sensitivity of the public finances and the rouble to the oil price. Thus when international prices exceed the price set in the budget, the finance ministry uses the excess revenue to build up the National Wealth Fund (by buying foreign currency via the central bank). Conversely, below certain price levels, the finance ministry sells liquid assets (in dollars) from the National Wealth Fund to cover its financing requirements.