Russia

Sluggish economic growth

Economic growth slowed sharply in the first 5 months of the year and the central bank has revised downward its forecasts. To boost activity, the monetary authorities lowered their key rates by 25bp in June at a time when inflationary pressures had eased slightly. The government also took major steps to stimulate the potential growth rate, which has declined constantly since 2008-09. Despite the increase in public spending, the government continued to generate a big fiscal surplus in the first 5 months of the year. Although these measures are a step in the right direction, they must be accompanied by the state's disengagement from the economy and better corporate governance to generate a substantial increase in potential growth.

Economic growth slowed sharply in Q1 2019

The economy slowed sharply in Q1 2019, with growth of only 0.5% year-on-year (y/y), down from 1.9% in the year-earlier period.

This slowdown can be attributed to two factors: 1) the decline in oil production, in compliance with its OPEC commitments (renewed in early July for another 9 months), and 2) a slowdown in household consumption, triggered by a 2-point increase in the VAT rate on 1 January 2019. Investment growth also decelerated to 0.5% y/y in Q1 2019, from 3.8% in Q1 2018, especially in the real estate and hydrocarbon transport sectors.

Although activity rebounded slightly in April, the economy slowed sharply again in May, and growth prospects are still looking downbeat. In May, automobile sales contracted for the fourth consecutive month (-2.2% y/y) and in June, manufacturing PMI, which reflects business leaders' expectations, was below 50 for the second straight month.

A boost from monetary policy

After peaking at 5.3% in March, inflation has eased. Prices rose 5.1% y/y in May. The monetary authorities lowered their inflation outlook by 0.5 pp and are now forecasting inflation of between 4.2% and 4.7% at the end of the year (close to the 4% inflation target).

To stimulate domestic demand, the central bank took advantage of this environment to lower its key rates by 25 basis points (bp) to 7.5% at its June monetary policy committee meeting. Monetary policy should remain accommodating in the months ahead.

Activity is expected to accelerate in H2 2019, buoyed by monetary easing and the increase in government investment. For the full year, however, economic growth should remain sluggish, and the central bank has revised downwards its growth forecast by 0.2 pp to 1-1.5%. Growth will fall short of its long-term potential, which has declined over the past 10 years.

Growth potential continues to decline

Russia's potential growth rate has fallen sharply, from 3.8% in 2008-2009 to only 1.5% in 2018. According to the World Bank, it could shrink to only 1.3% by 2022 unless the government manages to reverse this trend.

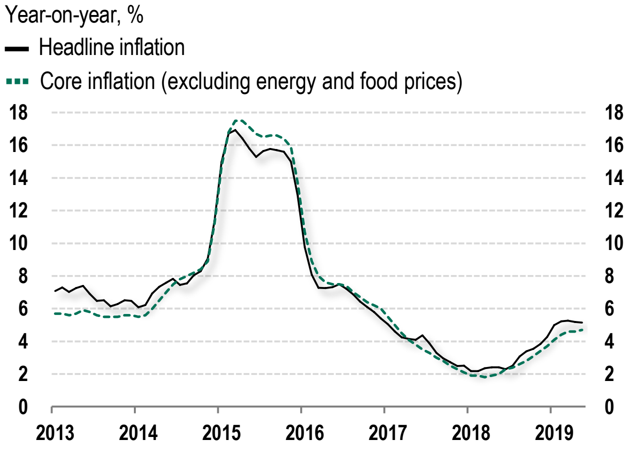
The slowdown in Russia's growth potential can be attributed to: 1) insufficient productive investment and 2) the decline in the labour force.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.6	2.3	1.2	1.8
Inflation (CPI, year average, %)	3.7	2.9	5.0	4.0
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	5.9	4.3
External debt / GDP (%)	32.8	27.2	26.6	23.8
Forex reserves (USD bn)	356	375	428	445
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: estimates and forecasts BNP Paribas Group Economic Research

2- Price increases are expected to peak in March



Source: CBR, CEIC

Following his re-election, President Putin announced several major reforms (*May Decree*) to stimulate potential growth. According to World Bank estimates, they could boost the potential growth rate by 1.2 percentage points by 2028. These measures include a gradual increase in the legal retirement age, an 11 pp increase in the investment rate to 34% of GDP by 2028, increased spending on healthcare, education and the quality of environment, and a more favourable demographic and migratory policy to counter population decline (first reported in Russia in 2018).

On 1 January 2019, the government began to raise the legal retirement age, a reform that should increase the potential growth rate by 0.3 to 0.4 pp according to the World Bank. In the first 5 months of 2019, spending on infrastructure, environmental protection and healthcare increased sharply, albeit without raising the total amount of public spending.

To stimulate private investment, however, the government must take its reform efforts much further by disengaging the state from the economy and improving the quality of governance. Although the overall business climate has improved [1], this mainly reflects improvements in the quality of infrastructure. In terms of governance, in contrast, Russia still scores fairly poorly. It ranked 162nd out of 211 countries in 2018 (which is only 5 ranks better than its score 5 years ago). Corruption, its main source of weakness, is still rampant: Russia ranks 138th out of 180 countries and is rated 28/100 by Transparency International. The World Bank estimates that an improvement in the business environment and state disengagement from the economy would boost Russia's growth potential by 0.3 pp.

Strong rise in the fiscal surplus

After reaching 2.6% of GDP in 2018, the fiscal surplus rose to 2.7% of GDP in the first 5 months of 2019. Increased spending as part of the economic development programme was partially offset by a decline in interest charges, which limited the total increase in spending to 5.3%, less than the nominal GDP growth rate.

At the same time, government revenues increased strongly, at an average annual rate of 13.7%, thanks to the increase in VAT revenue (+15.7%). The share of non-oil & gas revenues rose to 56.8%, 3pp more than in 2018. Oil & gas revenues only increased a moderate 6.9% due to cutbacks in oil production (in compliance with the OPEC+Russia agreement) and the decline in oil prices converted into roubles (-1.3% y/y in May). The government should continue to report a large fiscal surplus in 2019, albeit a smaller one than in 2018.

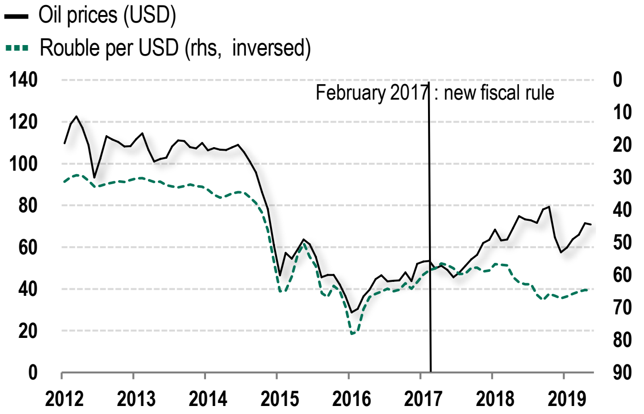
Government debt declined by 1.2 percentage points to only 14.3% of GDP in 2018.

Moreover, thanks to the central bank's foreign currency purchases on behalf of the Ministry of Finance ministry, the National Wealth Fund (NWF) should end the year at USD 124.6 bn (up from USD 58.7 bn at the end of May 2019). By the end of the year, USD 66 bn in foreign currencies purchased in 2018 will be transferred to the NWF.

Consolidation of external accounts

The Russian economy is still highly dependent on commodity price trends and is vulnerable to a tightening of US sanctions. Nonetheless, its resilience has been strengthened significantly since 2017. Foreign reserves have been partially rebuilt, the external debt has diminished sharply and the correlation between the rouble and oil prices is not as strong as it was two years ago.

3- Decline in the correlation between the rouble and oil prices



Source: Datastream

At the end of May, foreign reserves amounted to USD 405 bn, just USD 20 bn less than before the imposition of international sanctions in April 2014. They account for nearly 13 months of imports of goods and services, and cover 5.6 times the external debt maturing in less than one year.

After reaching 6.9% of GDP in 2018, the current account surplus rose to 8.9% of GDP in Q1 2019. It has increased rapidly over the past five quarters due not only to the increase in oil & gas exports (+0.7 pp to 15.9% of GDP), but also to other exported products (+0.7pp to 10.9% of GDP).

Total external debt was reduced by USD 52 bn over the past 12 months due to bank deleveraging and corporate debt reduction. The government's external debt increased but remains moderate, at 3.3% of GDP in Q1 2019.

The correlation between the rouble and oil prices has declined sharply, due notably to central bank purchases of foreign currency. In 2018, the rouble depreciated by 18% against the dollar, while oil prices rose 30.5%. The reduction in the correlation is also due in part to capital outflows between April and October 2018. In the first six months of 2019, the rouble appreciated by only 9% (despite portfolio investment inflows in Q1 and the central bank's foreign currency purchases), while oil prices rose by more than 17%.

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[1] Based on the Ease of Doing Business, Russia ranks 31st out of 189 countries (ahead of India and Indonesia).