Russia

Still large surpluses

In 2019, despite weak growth and a drop in oil revenues, Russia's macroeconomic fundamentals remained sound. This said, growth prospects remain weak despite disinflation and a relaxation of monetary policy. Standards of living are still low and the poverty rate has increased. The main threat to economic growth is a tightening of sanctions, even though the sharp increase in foreign exchange reserves, the rebuilding of the national wealth fund and the significant reduction in external debt are all factors that reduce the country's dollar financing requirement. A toughening of sanctions could hit foreign direct investment, which has fallen sharply over the last five years.

Growth prospects remain weak

Economic growth in Q3 2019 accelerated significantly to 1.7% (y/y) after growth of just 0.7% y/y in the first half. The agricultural sector has seen the strongest growth. Domestic demand recovered slightly, notably under the impetus of an increase in consumer spending, whilst exports continued to suffer from unfavourable global conditions. This upturn has been helped by a sharp fall in inflation and the resulting relaxation of monetary conditions. In November 2019, prices rose by only 3.5% y/y, below the 4% target rate set by the monetary authorities. Against this background, in December 2019, the central bank made its fifth consecutive cut to its policy rate, taking it to just 6.25%, its lowest level since 2014. Lending rates (in both nominal and real terms) and rates on government 10-year bonds both fell significantly over the course of last year. Ten-year rates were just 6.5% in mid-December (from 8.8% a year earlier), lower than they were before the crisis of 2014.

Although growth consolidated in Q4, it is unlikely to have exceeded 1.1% over the whole of 2019 (from 2.3% in 2018).

In 2020, economic growth is likely to benefit from a favourable basis of comparison. More fundamentally, the fall in inflation and the continuation of monetary relaxation in the first half of 2020 will continue to boost private investment and, to a lesser degree, consumer spending. Labour market conditions will continue to be favourable. Similarly, government investment should continue to increase, as the result of the introduction of development projects. However, the net contribution of exports to growth is likely to remain negative. Under the latest agreements with OPEC, signed in December 2019, Russian oil production is likely to be cut by 95,000 barrels per day in Q1 2020 relative to November 2019 production levels (an 8.4% cut).

Other than a sharp fall in oil prices, the main threat to the Russian economy is a tightening of sanctions, which would affect investment.

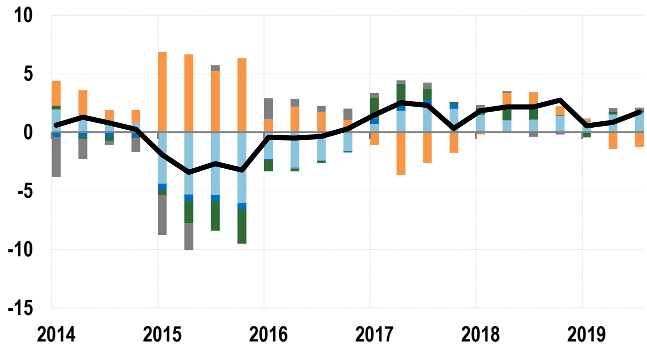
Predicted growth (1.6% in 2020 and 1.8% in 2021) remains too low to bring any significant increase in income levels for Russia's population. According to the IMF, per capita income in USD terms in 2021 will still be 26% below pre-crisis levels. Meanwhile, although the unemployment rate has hit a low point, at just 4.4% in Q3 2019, the increase in real income has slowed following the increase in VAT. In Q2 2019 there were 19.8 million people living in poverty (some 13.5% of the population), compared to 16.1 million in 2014 (11.2%).

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	2.3	1.1	1.6	1.8
Inflation (CPI, year average, %)	2.9	4.5	3.7	4.0
Central Gov. balance / GDP (%)	2.9	1.6	1.0	0.6
Public debt / GDP (%)	14.3	14.9	15.2	15.5
Current account balance / GDP (%)	6.9	4.3	3.3	3.0
External debt / GDP (%)	27.5	28.5	29.0	29.5
Forex reserves (USD bn)	375	433	470	510
Forex reserves, in months of imports	12.8	13.0	13.2	13.3
Exchange rate USDRUB (year end)	69.4	61.9	65.0	66.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Growth remains weak



Source: CBR, CEIC

Demographic change and the weakness of productive investment have structurally depressed growth. The active population has fallen steadily since 2012 and, according to the World Bank, this trend is likely to continue through to 2027, despite the raising of the retirement age.

Meanwhile, the rate of investment growth has slowed sharply since 2009 (2% per year on average between 2009 and 2018, from 12.5% from 2000 to 2008). In addition, although the level of investment has remained relatively stable, at 23% of GDP, the structure of investments has changed. According to the Conference Board, the share of productive investment has fallen in favour of construction investment, holding back technological progress. The stock of private capital had fallen to 159% of GDP by 2017, from 282% of GDP in 2000.

Public finances will remain robust

Over the first ten months of 2019, the government's fiscal surplus was 3.5% of GDP, despite a drop of more than 1 percentage point (pp) in income from oil and gas sources (7.6% of GDP). This strong performance in the public finances was made possible by the big jump in VAT receipts (up 16.7%) which contributed to the 1pp increase in non-oil and gas receipts, taking them to 11.3% of GDP, a level not seen since the period from 2000 to 2008 (when growth was running at an average of 7%). Spending remained controlled over the first ten months of the year (up 6%), despite the increase in investment in October. This took investment to 66.1% of the annual target set under the medium-term development programme.

For 2019 as a whole, the government is likely to record a surplus of 1.6% of GDP, which will gradually fall to 0.6% of GDP by 2021 as oil revenues fall and spending rises.

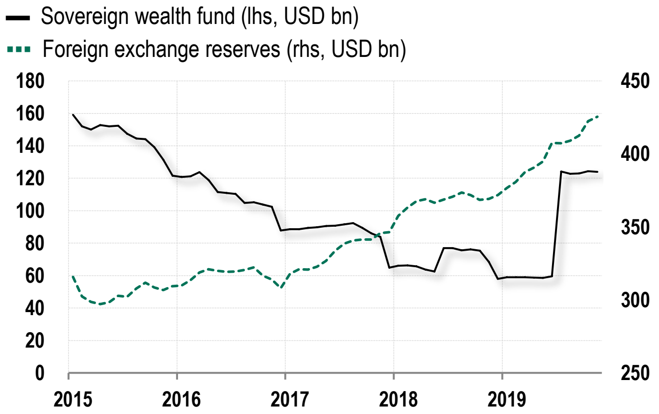
Having fallen steadily since 2015, government debt stood at only 14.9% of GDP in Q2 2019. This is likely to rise gradually over the next five years, as part of the investment between 2019 and 2024 (estimated at 1.1% of GDP per year) will be financed by debt issuance. The structure of debt remains low-risk and has been little affected by the sanctions introduced in August 2019. Although the government's external debt (i.e. that held by non-residents in both local and foreign currencies) has risen, it stood at only USD 64.5 billion in Q3 2019, with more than 63% of the total denominated in rubles (USD-denominated debt was just USD 22.9 billion, or 36% of the total). Moreover, the government can always draw on its sovereign wealth fund, the National Wealth Fund, to finance part of its investment spending. This has been rebuilt, to some extent, and stood at USD 124 billion on 1 December 2019, the equivalent of 7.3% of GDP, from 4.4% of GDP in December 2018.

External accounts also remain strong

Since the crisis of 2014-15, Russia's external accounts have strengthened. External debt has fallen by 34% from its high point of 2013 (taking it to just USD 471 billion in Q3 2019), the dependence on dollar financing has eased (the share of dollar-denominated external debt was 49% in Q2 2019, from 61% in 2013) and the ruble and the oil price are no longer as tightly correlated. However, diversification of Russian exports is still limited and FDI has fallen significantly over the past five years, in line with the introduction of international sanctions.

Foreign exchange reserves reached USD 436 billion in November 2019, an increase of USD57 billion on a year earlier. They are now back close to their highs of 2013 (USD 486 billion) and cover external debt service costs 4.5 times over. This increase in reserves came mainly from foreign currency purchases by the central bank (for a total of USD 42 billion over the first eleven months of 2019), with a smaller contribution coming from the current account surplus.

3- Foreign currency reserves and sovereign wealth fund



Source: CBR

The current account stayed in surplus over the first nine months of 2019, albeit at a lower level than in 2018. It was equivalent to 4.7% of GDP, from 6.2% at the same point of 2018. This slight reduction reflected the shrinking of the trade surplus in Q2 and Q3 2019, resulting from lower exports of oil and gas (price and volume effects).

Over the first nine months of the year, net outflows of capital fell sharply from their level in the same period of 2018 when the tightening of US sanctions triggered sizeable precautionary movements by foreign investors. Over the second and third quarters of 2019, the financial account recorded net capital inflows.

This improvement in external accounts since the 2014-15 crisis needs to be seen in context. First, excluding oil and gas, the current account was in deficit to the tune of 9.8% of GDP over the first three quarters of 2019, reflecting the economy's high level of dependence on energy exports. In 2018, raw materials still represented 67% of Russian exports. Secondly, FDI has fallen steeply since sanctions were introduced in 2014. Between 2014 and 2019, new investment (excluding reinvestment of profits) ran at an average of only USD 4.9 billion per year, compared to USD 32.5 billion per year between 2008 and 2013. It is hard to identify the origin of FDI into Russia, given the substantial movements of capital that come via Cyprus and the Netherlands. Even so, FDI from Europe and the USA fell by 88% and 41% respectively between 2015 and 2018, whilst investment from Asia increased by a factor of 5.2. However, the rapid decline in FDI from the west has hampered the diversification of the economy. FDI from Asia is tightly focused on the energy sector, whilst that from Europe and the US was spread across several sectors.

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