RUSSIA

A FRAGILE RECOVERY BUT RESILIENT FUNDAMENTALS

The scenario of a partial and still fragile economic recovery is confirmed against a backdrop of a spreading pandemic at end-2020. Household consumption is the only component that managed to contribute to growth, but it could run out of steam with the upsurge in inflation. The recovery is expected to broaden in 2021, thanks to the expected resumption of production in the extractive industries, higher oil prices and the improvement in business confidence in the manufacturing sector. Yet monetary and fiscal supports will be relatively small. Public finances have been fairly resilient, and foreign reserves have consolidated despite capital outflows, since the rouble served as the adjustment variable. According to the Central Bank of Russia (CBR), the banks have sufficient reserves to cover the entire amount of restructured loans.

AS THE PANDEMIC SURGES IN LATE 2019, A VACCINATION CAMPAIGN IS ROLLED OUT

Russia has had to cope with a surge in the Covid-19 epidemic since Q4 2020. The number of new cases has increased 4-fold between late September and early January. So far, the official figure is 60,000 deaths, or a fairly low mortality rate of 408 deaths per million inhabitants. But the official figures probably underestimate the scope of the pandemic. A vaccination campaign was launched in early December using the Sputnik V, a locally developed vaccine, even though clinical trials have yet to be completed. The first phase of the vaccination campaign targets medical professionals and teachers (after military personnel) as well as individuals over age 60. In early January, 800,000 individuals had been vaccinated. Deployment of the vaccination will necessarily take a long time, both in terms of vaccine production and covering of the population (140 million inhabitants), especially since, according to various polls, close to 60% of Russians were reticent about being vaccinated.

A PARTIAL, FRAGILE RECOVERY

The Russian economy was hit by a smaller recessionary shock than in most of the other emerging countries. Since Q2 2020, however, activity has barely levelled off. On a year-on-year basis (y/y), GDP was still contracting 4% on average in October-November, vs -3.4% in Q3 2020. Based on these preliminary estimates, GDP will still fall 3.5% short of the Q1 level. In November, oil production amounted to 9.3 m barrels/day (mb/d), a 12% decline from the Q1 figure, mainly due to OPEC+ oil production quotas. Natural gas production was also down 6% compared to Q1. Excluding the extractive industries, activity plummeted in the hotel & restaurant, leisure and transport sectors, down between 10% and 25% in volume between January and September 2020, compared to the same period in 2019. In contrast, manufacturing and construction were both more resilient. In November, manufacturing activity even grew 1% y/y.

An analysis of the components of demand, however, underscores the fragility of the recovery. In Q3, private consumption was the sole growth engine (3.7% q/q seasonally adjusted). In contrast, public expenditure and investment failed to pick up. Net foreign trade even made a negative contribution to growth due to the ongoing decline in exports.

Worse, the rebound in consumption seems to be winding down. On average in October-November, retail sales were still declining 2.2% y/y. Two powerful tailwinds are 1) rising unemployment (6.1% in November vs. 4.6% in Q1), and 2) accelerating inflation (4.9% y/y in December, vs 2% in Q1). With the surge in food prices (+6.7% y/y in December), the government opted to introduce targeted price controls. Monetary policy easing through the summer combined with measures to subsidize mortgage rates for households mainly helped stimulate mortgage loans.

Despite incentives to encourage investment in housing, total investment remained sluggish until Q3, due to the climate of uncertainty and declining exports. Gazprom scaled back its investments by 18% in 2020.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	1.3	-4.5	3.8	3.0
Inflation (CPI, year average, %)	4.5	3.4	3.5	3.5
Central Gov. balance / GDP (%)	1.9	-4.0	-1.5	1.1
Public debt / GDP (%)	14.1	18.6	18.8	16.5
Current account balance / GDP (%)	3.8	1.9	2.5	2.0
External debt / GDP (%)	28.5	31.0	29.0	27.0
Forex reserves (USD bn)	444	450	453	455
Forex reserves, in months of imports	15.1	16.9	16.0	15.5
Exchange rate USDRUB (year end)	62.1	74.0	72.0	70.0

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

A STILL PARTIAL RECOVERY OF ACTIVITY

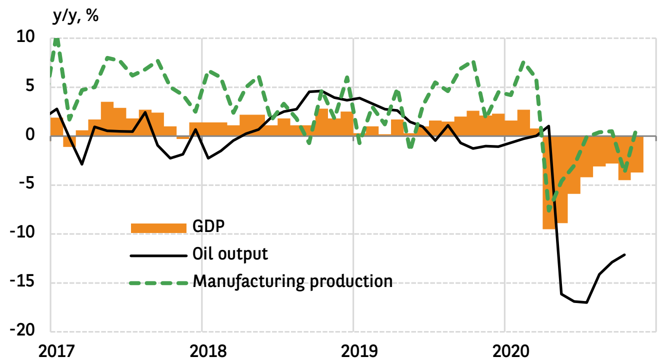

CHART 1 SOURCE: ROSSTAT, MINISTRY OF ECONOMIC DEVELOPMENT, JODI

Yet PMI indicators point to renewed confidence in the manufacturing sector. Moreover, non-hydrocarbon exports, which account for a little more than half of total exports, began accelerating again in September-October. If household consumption resists, investment could begin to contribute to growth again, providing a broader base for the recovery. We expect to see an improvement in the extractive industries, with a planned but moderate increase in oil production starting in February-March (+0.13 mb/d or an increase of 1.4% from current levels).

The recovery will still be restrained by the monetary authorities' lack of manoeuvring room due to inflationary pressures (the central bank's key policy rate has been held at 4.25% since July) and a cautious fiscal policy.

MILD IMPACT ON PUBLIC AND EXTERNAL ACCOUNTS

Apparently, the deterioration in public finances was relatively mild in 2020. After reporting fiscal surpluses in 2018 and 2019, the central government deficit should rise to 4% of GDP this year (the 12-month cumulative total was only 3.6% in November) reflecting the need for fiscal support. The budget also benefited from a BCR transfer of 1.1% of GDP. Even so, fiscal revenues have held up well. Consequently, the public debt ratio will hold at 15-20% of GDP at year-end 2020 (it was only 16% of GDP in September), despite the rouble's sharp depreciation (sovereign debt in foreign currencies still accounts for 17% of the total). In 2021, the government expects to have a little more manoeuvring room in terms of spending to avoid hampering the recovery, but regulated withdrawals from the National Wealth Fund (NWF) will be limited to 1% of GDP, even if oil prices were to plunge again. At the end of October, NWF assets were valued at USD 177 bn (11.5% of GDP) compared to USD 125 bn at year-end 2019.

On the external side, the current and financial accounts all carry traces of the decline in oil prices and the outflow of non-resident portfolio investments. According to BCR estimates, the current account surplus was reduced by more than half in January-November, compared to the same period in 2019, while the deficit of financial transactions of the private sector widened by nearly 80%. Even so, Russia managed to consolidate its foreign reserves. Another positive point is that part of the capital outflows were due to the external deleveraging of non-financial private sector companies and banks (by USD 12.8 bn and USD 4 bn, respectively, between year-end 2019 and September 2020).

The main adjustment variable was actually the rouble, which depreciated by 17% between the end of December 2019 and April 2020, before stabilising with some difficulty thereafter. Once again, the Russian currency is highly correlated with oil prices, despite BCR interventions to sell dollars up to mid-January. The rouble should get some support from oil prices, assuming they continue to rise. However, the BCR has resumed buying USD on the fx market since January 15. Yet the rouble's potential appreciation is likely to be hampered by other more structural factors, such as the revision of tax agreements with offshore centres (notably Cyprus) and the diversification of investment savings by wealthy households into instruments denominated in foreign currencies.

CREDIT RISK IS MANAGEABLE FOR THE BANKING SYSTEM

According to BCR, corporate debt has increased by 9.3 points of GDP since the beginning of the crisis due to the recession and the automatic impact of the rouble's depreciation. At 62.6% of GDP, corporate debt is still lower than its peak at year-end 2015 (70.8% of GDP). Service sector companies and SME have obviously been hit hardest (notably air transport, although it benefits from government support). However, the tourism, hotel and catering sectors account for a small share of all bank lending (1.1%). Production quotas and the decline in oil prices have weakened the hydrocarbon sector, but its debt burden is still moderate and the financial situation is stable. Higher oil prices and, to a lesser extent, increased production should help consolidate the sector.

Despite the recession, the ratio of loss loans and problem loans has remained practically unchanged at 10.7% between March and October. At the same time, however, the banks have restructured RUB 6.6 trillion in loans (about 9% of all loans), including RUB 5 trillion for major corporations, RUB 0.8 trillion for SME and RUB 0.8 trillion for households. Restructured loans are concentrated in the oil and natural gas sector (14%), the metal industry (13%), commercial real estate (12%) and the SME segment, all sectors combined (13%).

The need for additional provisions depends on the classification of restructured loans prior to restructuring. For now, the BCR allowed banks to postpone their provisioning needs for all loans (including restructured loans) through 1 April for major corporate loans and through 1 July for loans to households and SME.

Using the average provision coverage ratio observed for problem loans (52%) and assuming that these loans and those in the category just above them were restructured, the need for provisions would be RUB 1.6 trillion (i.e. 2.2% of all loans)[1]. Although provisioning charges will probably continue to rise, the increase in restructured loans slowed sharply in H2, for both companies and households alike.

Lastly, according to BCR, the banks' macro-prudential reserves account for 9% of all loans, which is largely sufficient to absorb any losses.

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1 The maximum is estimated at EUR 3.3 trillion if no provisions had been made for any of the restructured loans.