# Russia

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Prepared for the forecast delivered
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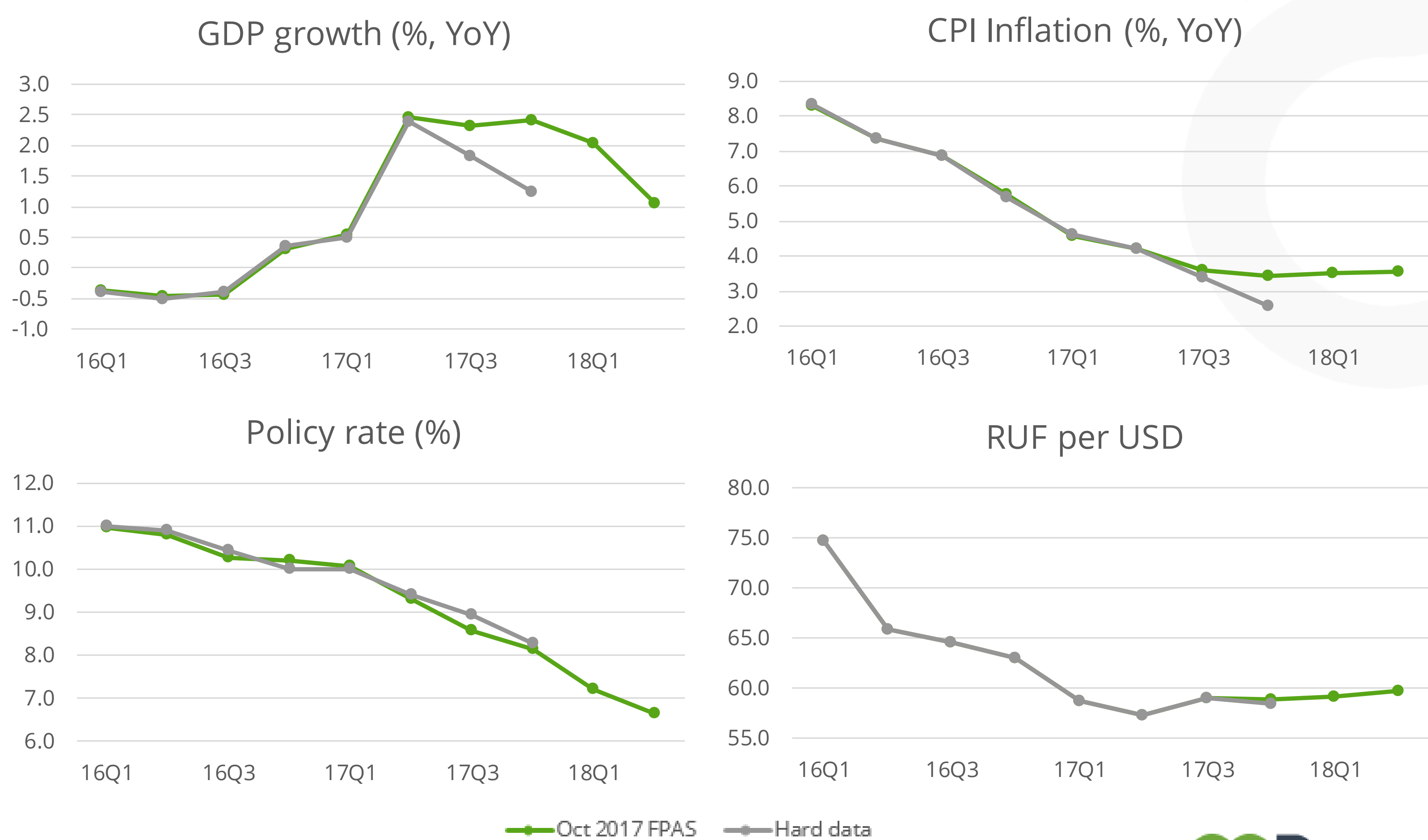
# Forecast story of previous FPAS in October 2017

- We expected a continuing recovery and high resilience of the Russian economy, albeit medium term growth outlook remained meagre.
- Despite the bailout of two major private banks, no systemic crisis was expected.
- The CBR was forecast to gradually continue monetary loosening given favorable price dynamics and below-target inflation.
- The nominal exchange rate was foreseen to depreciate mildly as a result of the high inflation differential combined with modest real appreciation.

# Incoming data is mostly in line with the October forecast…



# ...except for an unexpected slump in GDP in 2017H2

| | 2017Q3 | 2017Q4 |
|---|---|---|
| **GDP YoY, %** | | |
| Oct 2017 FPAS | 2.3 | 2.4 |
| Hard Data | 1.8 | 1.3 |
| Deviation (pp) | -0.5 | -1.2 |
| **CPI YoY, %** | | |
| Oct 2017 FPAS | 3.6 | 3.4 |
| Hard Data | 3.4 | 2.6 |
| Deviation (pp) | -0.2 | -0.9 |
| **RUF per USD** | | |
| Oct 2017 FPAS | | 58.8 |
| Hard Data | | 58.4 |
| Deviation (%) | | -0.6 |
| **Policy rate, %** | | |
| Oct 2017 FPAS | 8.6 | 8.1 |
| Hard Data | 8.9 | 8.2 |
| Deviation (pp) | 0.4 | 0.1 |

# No major changes in our February 2018 forecast story

- Growth will be driven by household demand in 2018 as the mining sector keeps production flat in line with the OPEC agreement. However, due to the lack of reforms to diversify the economy and improve institutional quality, medium term growth outlook remains subdued.

- We expect the central bank to carry on with its easing cycle to support the economy and helping inflation to return to target.

- The ruble is foreseen to show modest depreciation in the medium-term due to the net effect of an inflation differential to trading partners and modest real appreciation. Additionally, the new fiscal rule helps to reduce domestic effects of oil price volatility and FX reserves are ample.

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# No major changes in our February 2018 forecast story

- The bail-out of another major privately owned bank by the CBR corroborates our view that albeit there are still skeletons in the closet, but the likelihood of a full-blown financial crisis is still low. Further consolidation of the banking sector is expected.

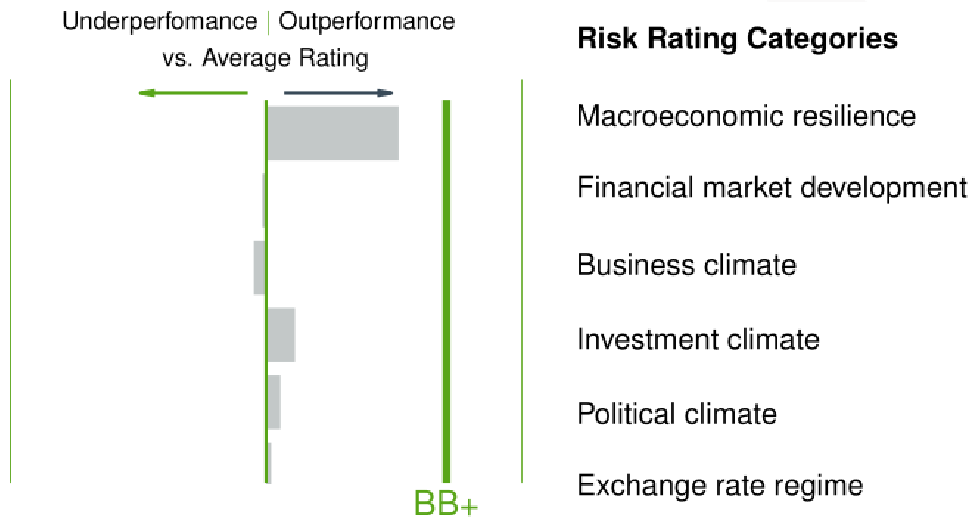
- Risks are high and tilted to the negative given the possibility of new sanctions, high dependence on oil revenues and banking sector woes.

# Russia maintains BB+ rating with stable outlook

BB+

equivalent of
Non-investment grade
speculative

Rating outlook:
Stable




*Source: macro.ogresearch.com*

- Russia's outstanding macroeconomic resilience is in contrast with its close-to-average performance in most indicators.
- Strong current account position, low external debt and large market size ensure macroeconomic stability.
- Rule of law, corruption and regulatory quality remain a fundamental drag on Russia's rating and economic potential.

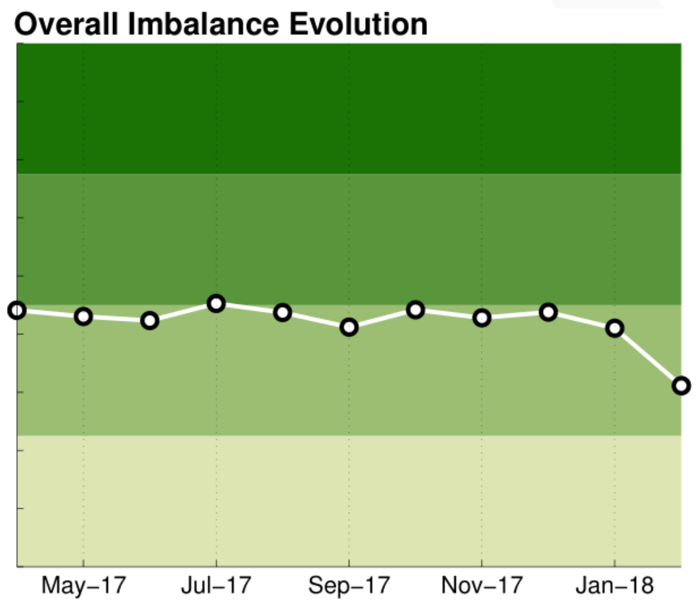
# OGR’s Overall Imbalance Indicator suggests slightly decreasing risks

| | |
|---|---|
| = | **Overall Imbalance** |
| ↑ | FX Reserves |
| = | Regional Distress |
| = | Overheated Demand |
| ↑ | Competitiveness |
| = | Asset Price |
| ↓ | Terms of Trade |
| = | Trade Balance |
| ↑ | Loose Monetary Policy |

| benign | neutral | negative | severe |
|---|---|---|---|
| ↑ improving | | ↓ worsening | |

Indicators are compared to three months ago.

For the definitions of the selected variables please refer to the glossary.




*Source: macro.ogresearch.com*

- The overall imbalance indicator monitors a number of crucial macro-fundamental variables on a monthly basis between forecast rounds weighted together based on OGR’s algorithm.
- In case of Russia, imbalances decreased slightly from end-2017 supported by the oil prices, suggesting that an adjustment through the nominal exchange rate or abrupt changes in economic policy is rather unlikely on the near term.

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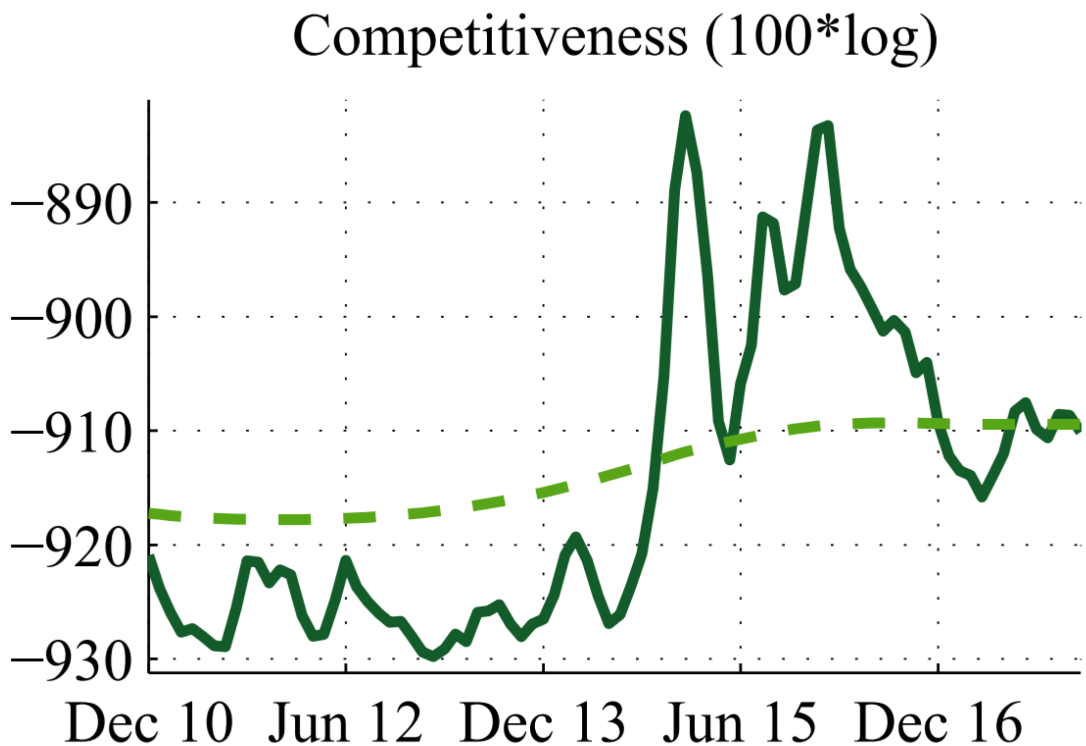
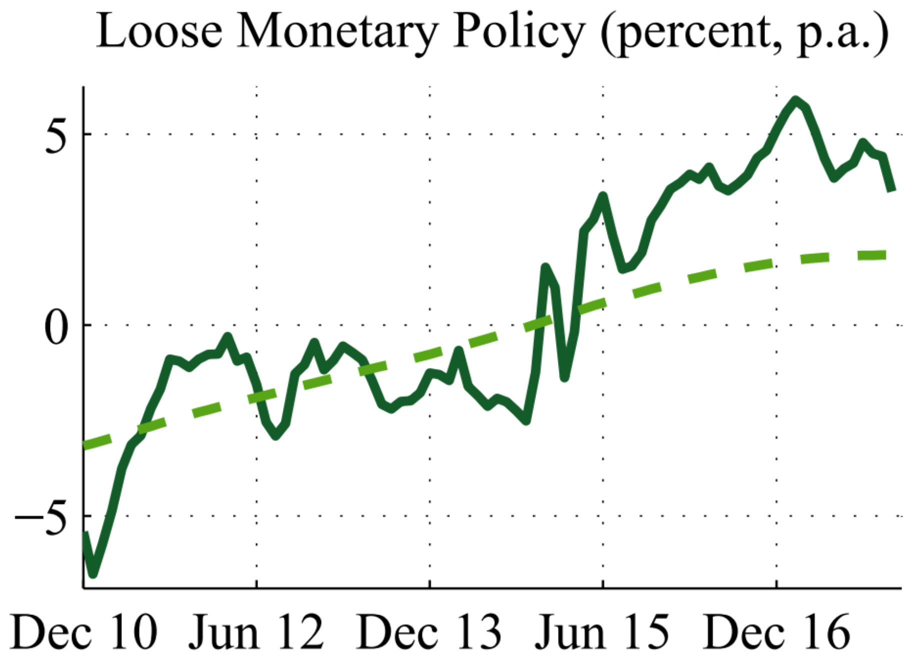
# Our measure suggest real exchange rate to be broadly in line with fundamentals




*Source: macro.ogresearch.com*

- The real exchange rate significantly corrected compared to 2015 peaks, but OGR measure suggests to be in line with fundamentals

# … but monetary conditions still remained rather tight



*Source: macro.ogresearch.com*

- CBR explains relatively tight conditions by not well anchored inflation expectations as well as uncertainty on global financial markets.
- We think that uncertainty over lingering US sanctions could also make CBR very cautious.

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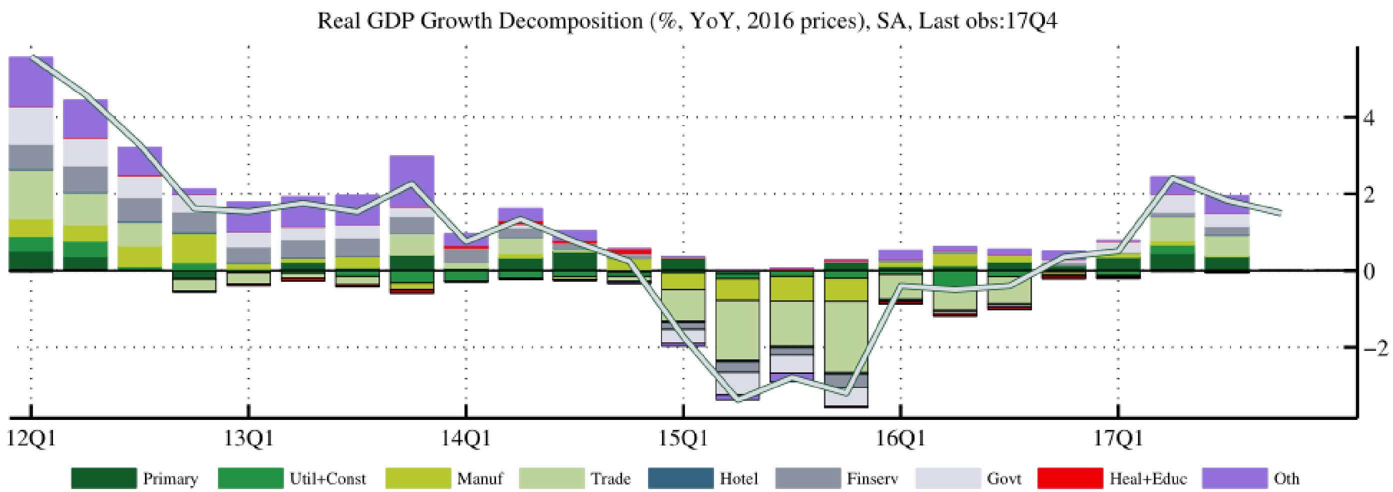
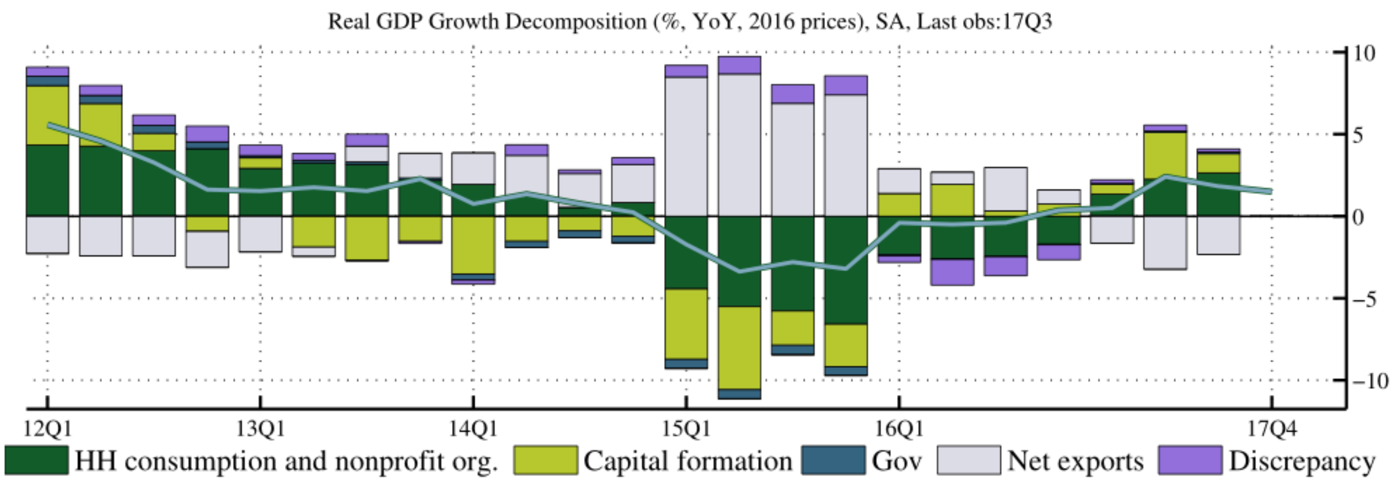
# Real Economy

# Growth momentum decelerated in the third quarter of 2017




- GDP growth decelerated to 1.8% YoY in 2017Q3.
- Despite a bumper harvest, slowdown in the mining sector rendered primary sector growth flat. Growth in crude oil production turned negative in September due to a high basis, while the warm weather conditions slowed down gas production.

# Growth momentum decelerated in the third quarter of 2017

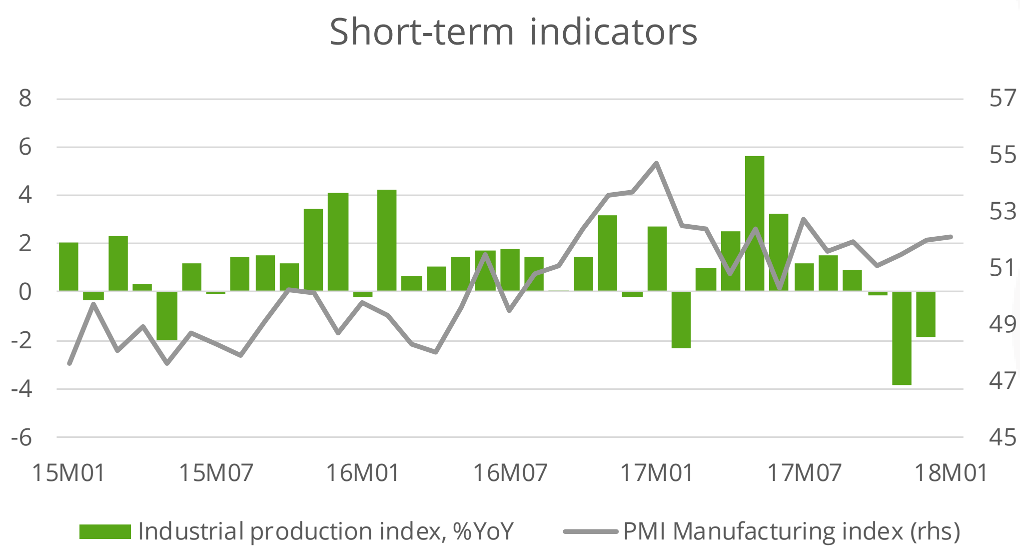



- A slowdown in gross capital formation came largely from reduced investment activity of large and medium-sized enterprises in mineral resource extraction and the fading out of temporary factors (e.g. inventory restocking and large government projects).

- Household consumption remained robust, supported by increasing real wages, improving consumer confidence, a strong ruble and higher lending flows.

- Net exports remain a drag on growth as households fuelled goods imports, while exports slowed on account of moderating mining activity.

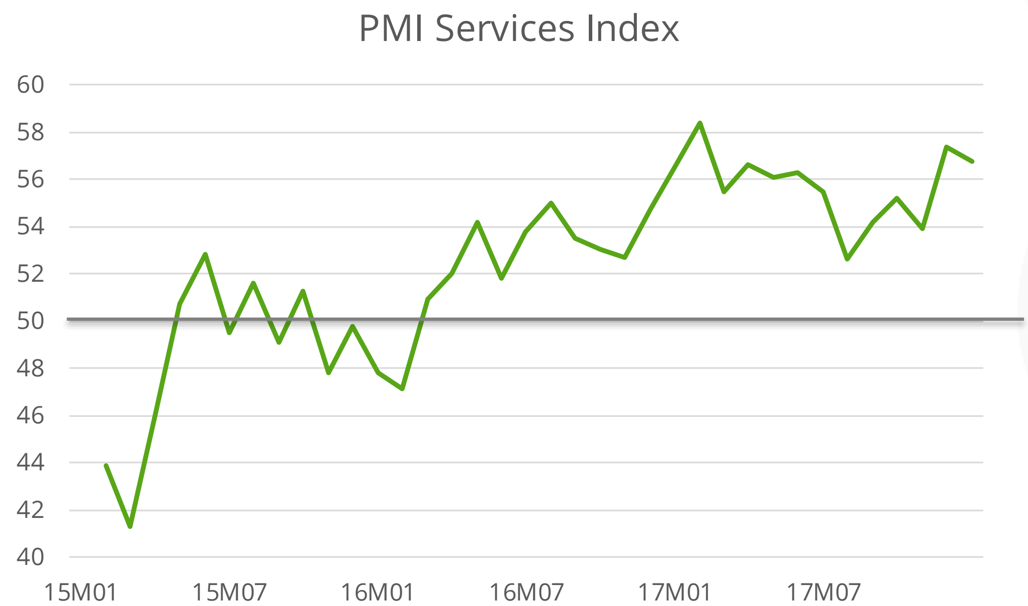
# Preliminary indicators suggest further industrial slowdown in 2017Q4…




- Monthly GDP dynamics slowed down to 1% in October, while in November, GDP fell by 0.3% YoY. The main negative contribution to GDP was made by dynamics of industrial production (-1.2 pp). In December, high-frequency indicators suggest an improving but still negative industrial activity.

- Decrease in manufacturing output was due to a sharp decline in two industries, *metallurgy (related to production cuts due to the OPEC deal)* and *production of other vehicles and equipment*. Nonetheless, overall manufacturing PMI still shows positive momentum, which could indicate some correction in 2018Q1

# … while the services sector PMI remains robust




- December data indicated a steep expansion in business activity across the Russian service sector.

- Composite new order growth was reflected in solid job creation in the service sector, with employment levels increasing at the second-fastest pace since May 2013.

- Preliminary estimate of overall growth for 2017Q4 is 1.3%.

# External forecasters show consensus on modest medium term growth outlook

| GDP | 2017 | 2018 | 2019 |
|---|---|---|---|
| OGR 201710 | 1.9 | 1.5 | 1.4 |
| EBRD 201711 | 1.8 | 1.7 | - |
| CBR 201712 | 1.95 | 1.75 | 1.25 |
| WB 201801 | 1.7 | 1.7 | 1.8 |
| IMF 201801 | 1.8 | 1.7 | 1.5 |
| EIU 201801 | 1.8 | 1.7 | 1.8 |
| Bloomberg 201801 | 1.74 | 1.92 | 1.57 |

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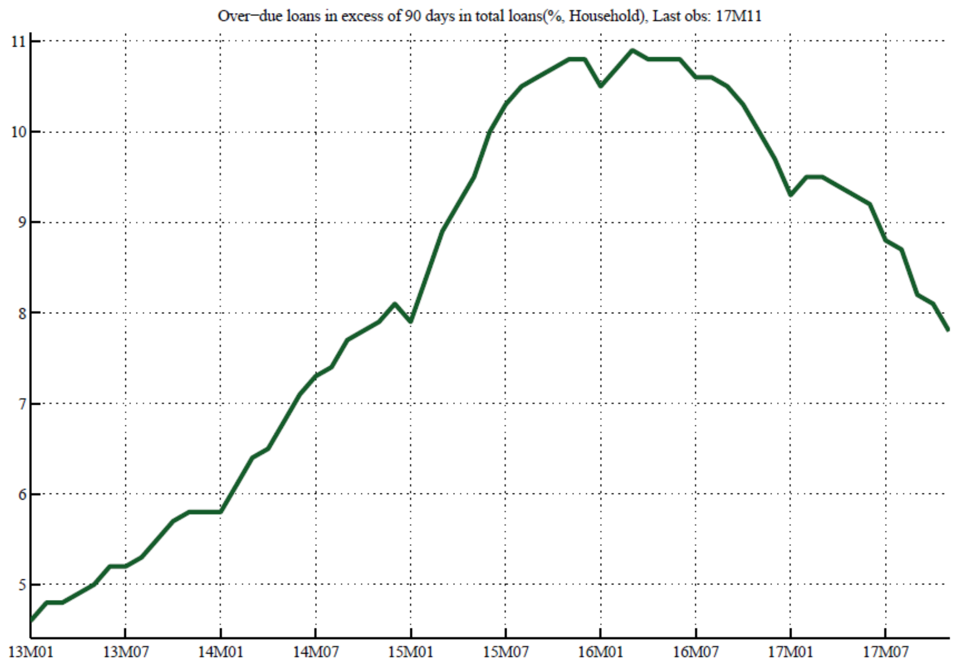
# Banking Sector

# The 10th largest bank was bailed-out in December…

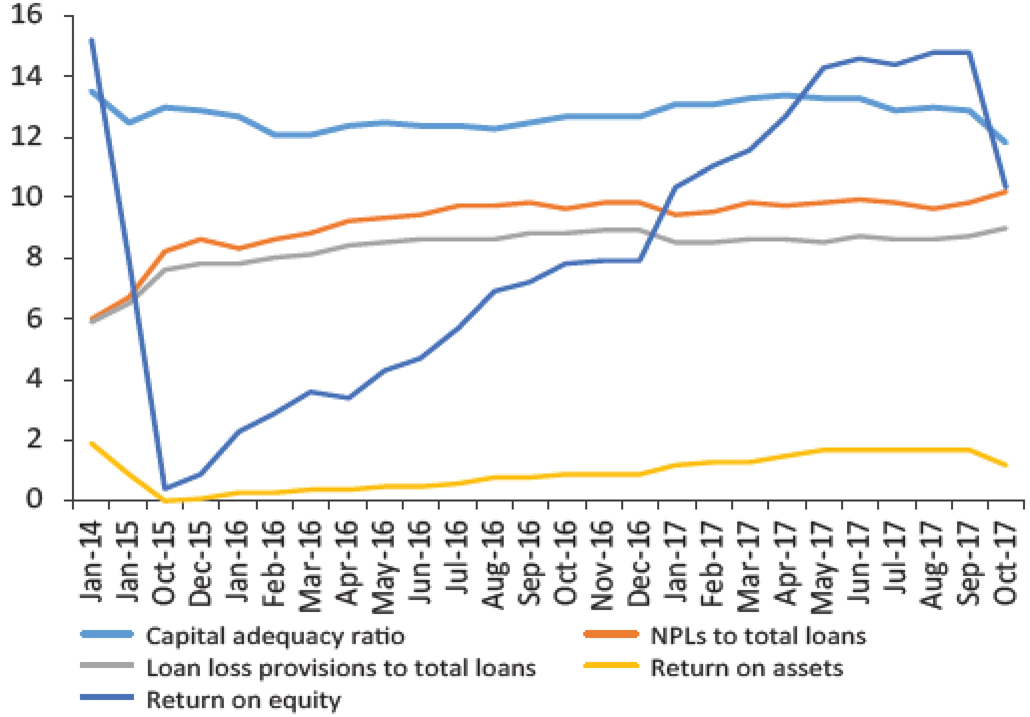
- Promsvyazbank's (PSB) bailout was initiated by the central bank, following an examination of the bank's assets.
- Estimated costs reach RUB 100-200bn ($1.7-3.4 or 0.1-0.2% of GDP).
- The rescue follows the central bank bailout in August of Otkritie, once the country's largest private bank, and later B&N Bank.
- We maintain that further bailouts are expected during the consolidation process in the short term, but a full-blown financial crisis is unlikely.

# Despite declining official NPL-s…




- While overall NPLs are declining, the distribution of problem loans is uneven: large, state-owned banks and foreign-owned banks are in a better situation than small, non-foreign owned private banks.
- Furthermore, other sources estimate the level of problematic loans at 12-18% of total.

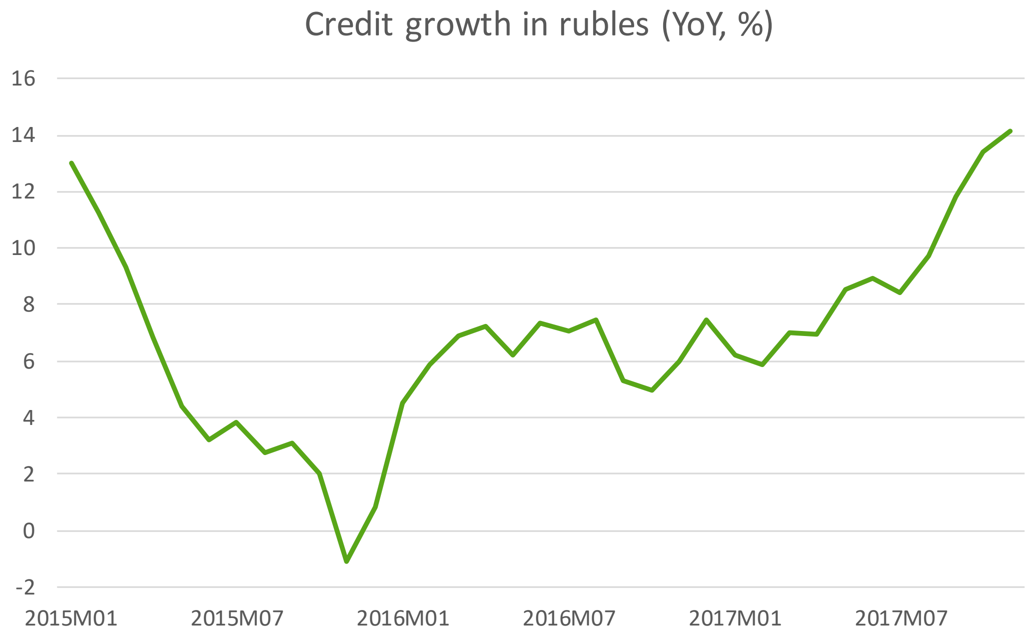
# ...capital adequacy deteriorated on account of increased provisioning




*Source: World Bank: Russia Economic Report*

- Key performance indicators weakened slightly. The problematic banks under CBR supervision were asked to increase provisions in Q3 which led to a fall in aggregate profitability and capital adequacy.

# Credit activity continued its pick-up in 2017H2




- Lending growth was uneven: while corporate lending experienced modest, single-digit growth, retail lending in rubles increased by over 10% YoY in 2017. High retail lending occured partly on account of the fact that household real incomes still stagnated, while consumer demand was bouyant.

- The strongest growth was observed in the mortgage segment (>25%, YoY), supported by large unmet demand for housing and declining interest rates.

# A government mortgage program is expected to boost credit activity further

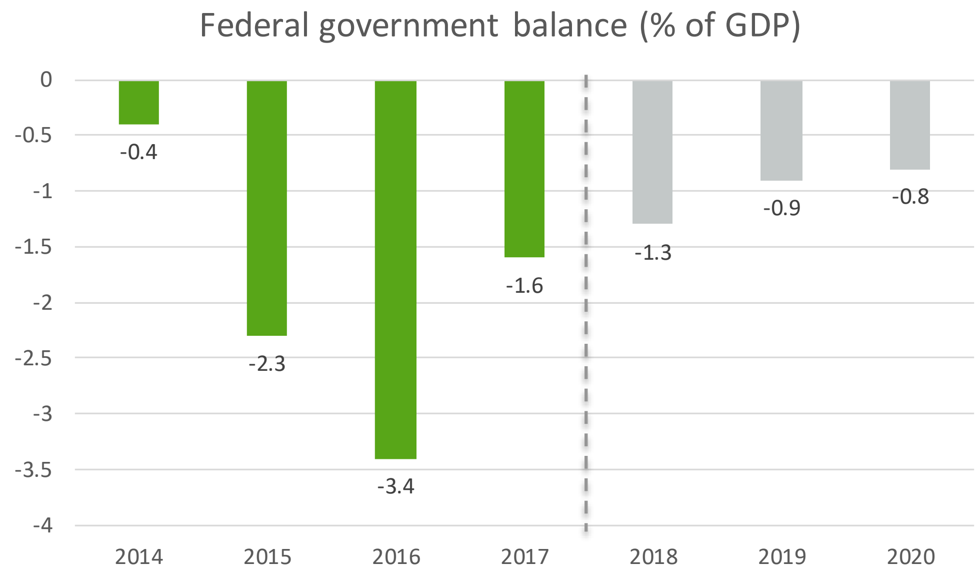
- A government decree issued on December 30, 2017 stated that families with a second or third child born between the years of 2018 and 2022 will be allowed to participate in the new governmental programme, fixing the annual interest mortgage rates to 6% for the period of three to five years (depending on the amount of children), significantly lower than current market rates of around 10%.
- More than 600,000 families will be eligible. The subsidy can be used only for financing apartments in new housing projects.
- Experts expect a boost to mortgage lending activity (already showing above 25% YoY growth in 2017) and the construction industry.

# Fiscal Policy

# New fiscal rule to smooth the effect of oil price volatility on the economy

- From 2017 February, the portion of the oil/gas revenue the federal government can spend in a given year is determined on the basis of fixed oil price benchmark of US$40 per barrel (at 2017 prices).
- The difference between the benchmark and actual price based revenues will be saved (in hard currency) in the National Welfare Fund (NWF).
- Concerning **fiscal policy**, the new fiscal rule should help moderate fiscal cyclicality by de-linking federal expenditure from commodity-price volatility and protect the NWF by restricting the use of oil/gas windfalls.
- Concerning **monetary policy**, the measure has the potential of decoupling the value of the ruble from the price of oil, by siphoning off any excess dollar revenues to the NWF.

# 2017 budget deficit hit 1.4% of GDP on the back of higher revenues




*Source: own calculations. Based on IMF Article IV (2017 July), budget law of 2018-2020 and January 2018 press conference with Finance Minister Anton Siluanov on final/planned numbers for 2017 and 2018*

- Better-than-expected revenue collection and stronger growth halved originally planned budget deficit of 3.2 to 1.6 percent of GDP.
- The budget deficit target for 2018 stands at 1.3 percent of GDP, while small pace of consolidation is announced for the rest of the years

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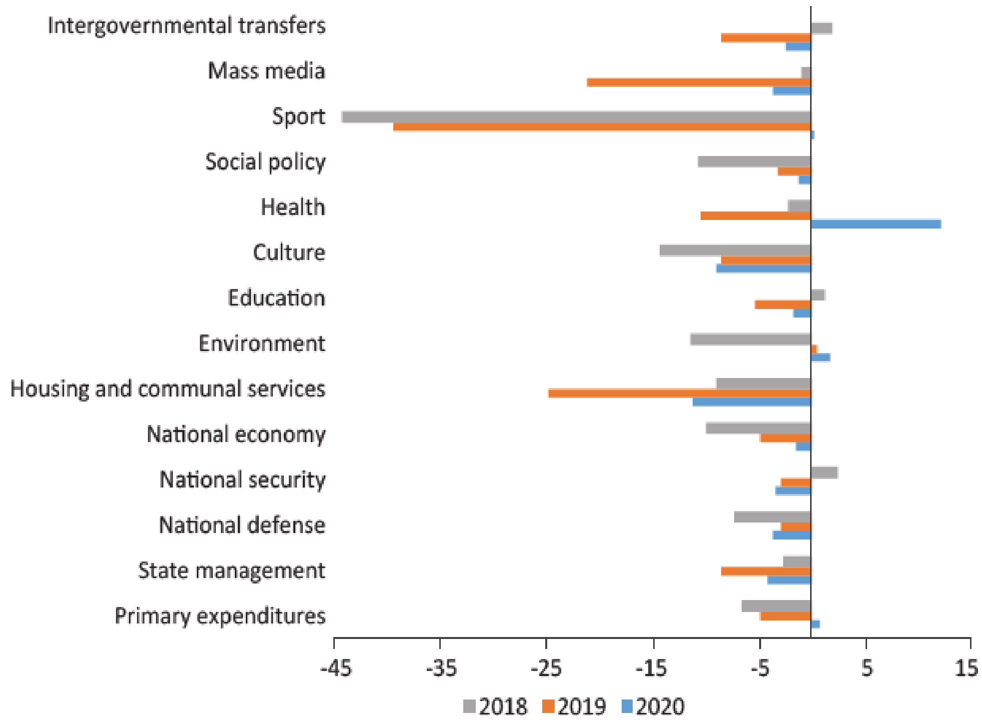
# The federal budget law for 2018-2020 is largely driven by expenditure cuts

## Percent changes relative to 2017 in government expenditure for all categories in real terms




*Source: Ministry of Finance.*

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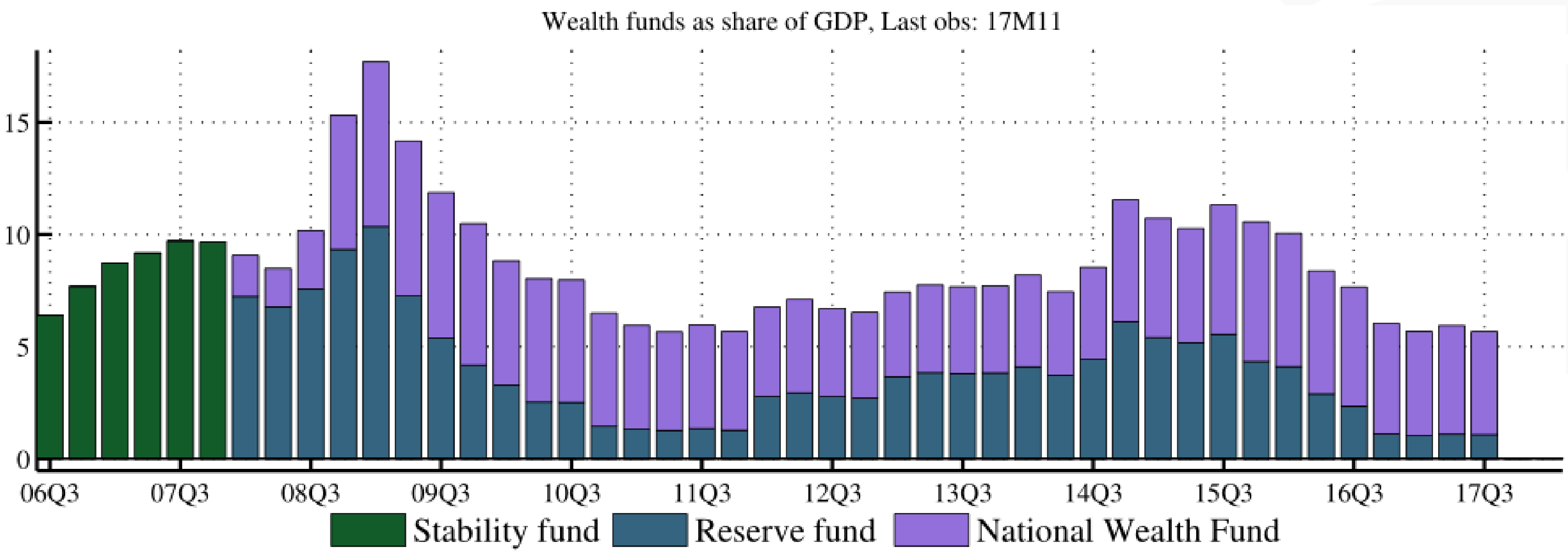
# Higher oil revenues helped to stabilize the Wealth Fund




- Despite continuous use in the budget, the Wealth Fund was stabilized by higher oil revenues
- National Wealth Fund to be merged with Reserve Fund from February 2018

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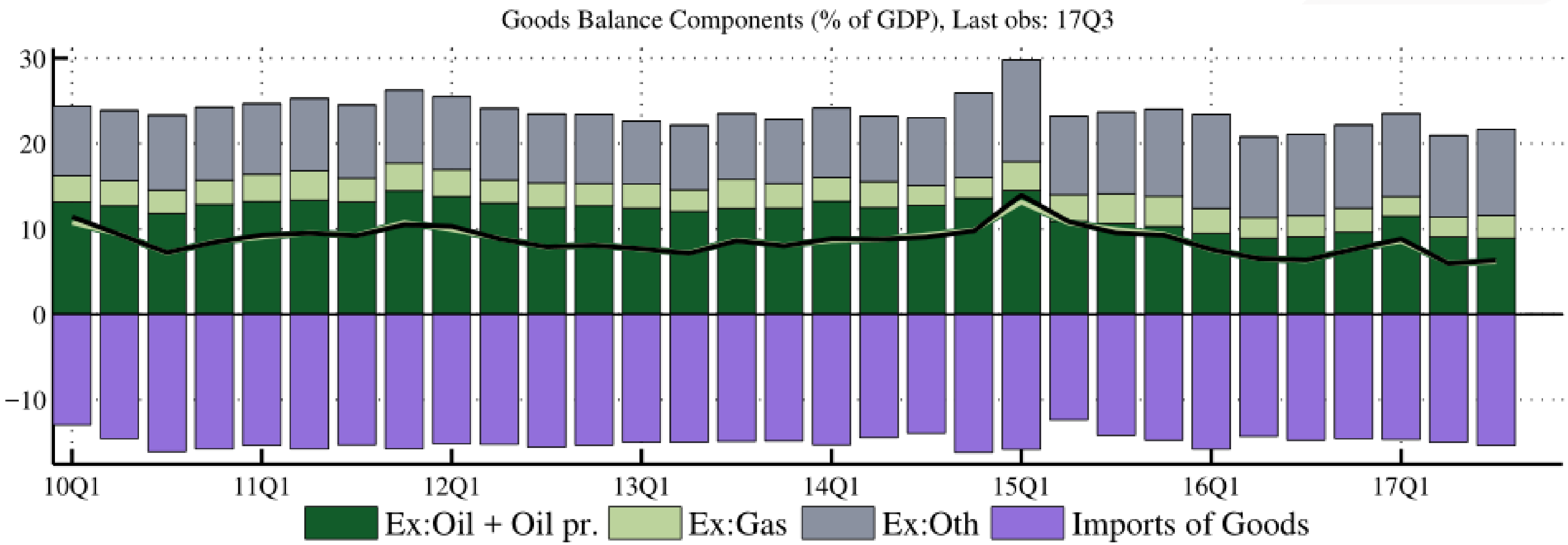
# External Balance and Financing

# Merchandise balance remained stable as oil price increase supported exports…




- …while imports increased slightly on the back of robust household demand

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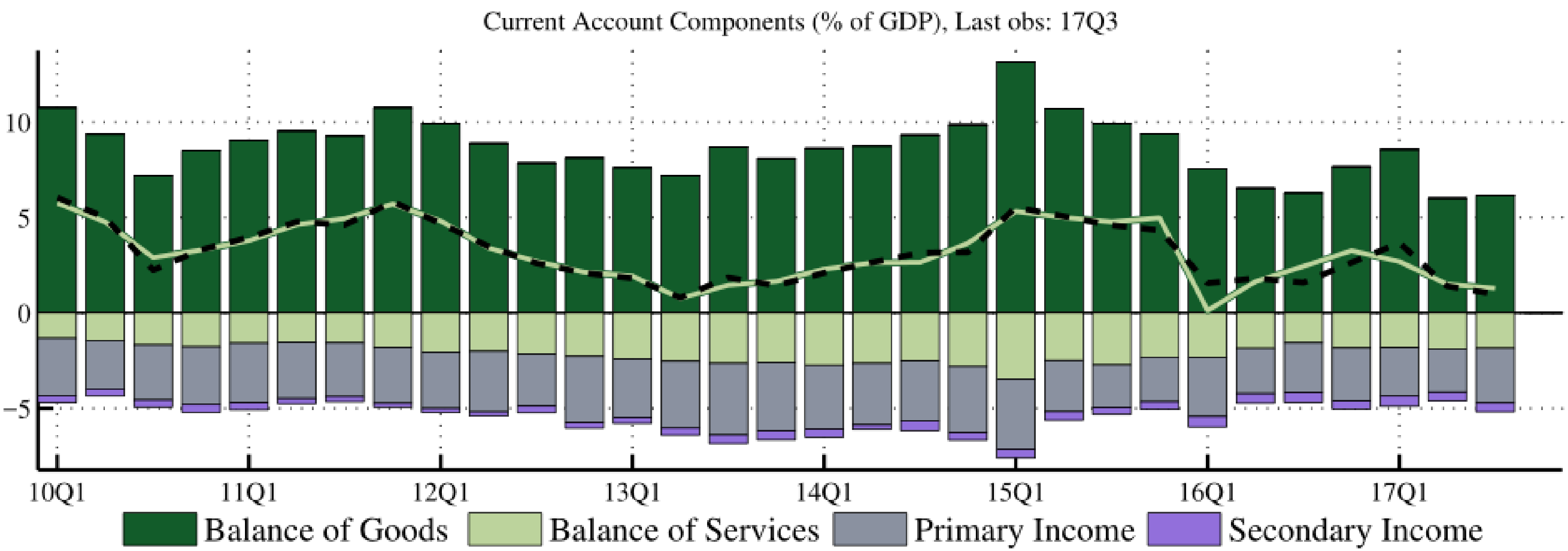
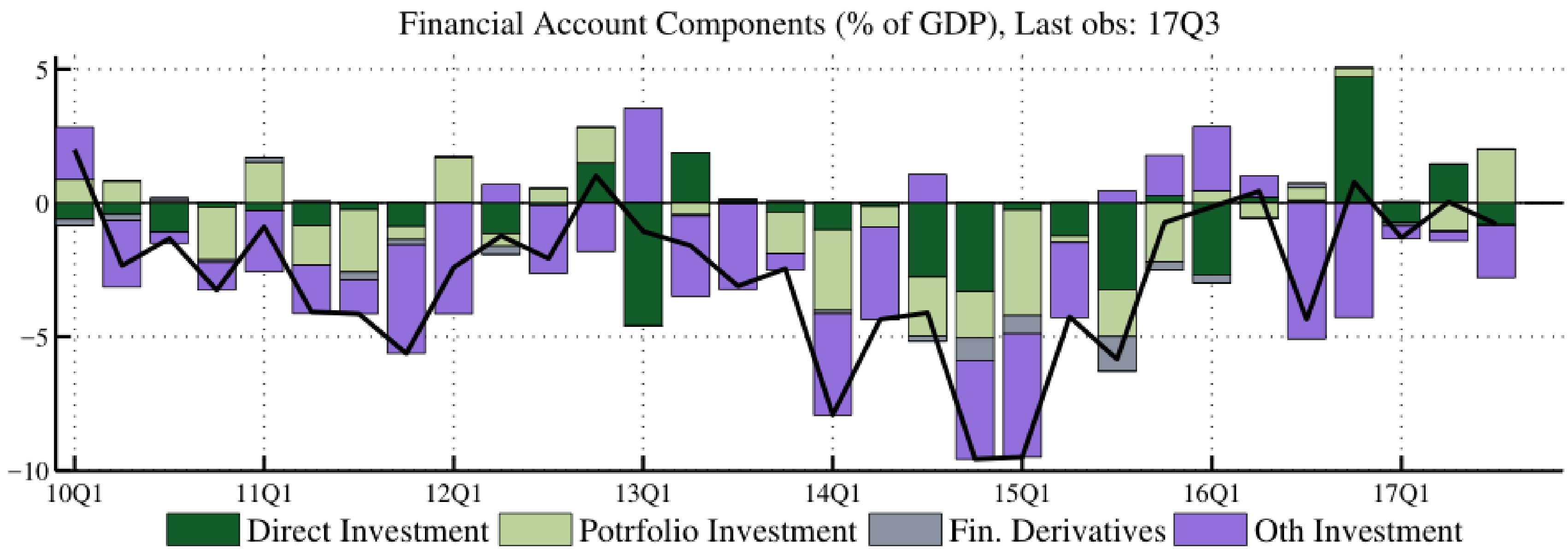
# … but the CA deteriorated slightly on the back of worsening income balance



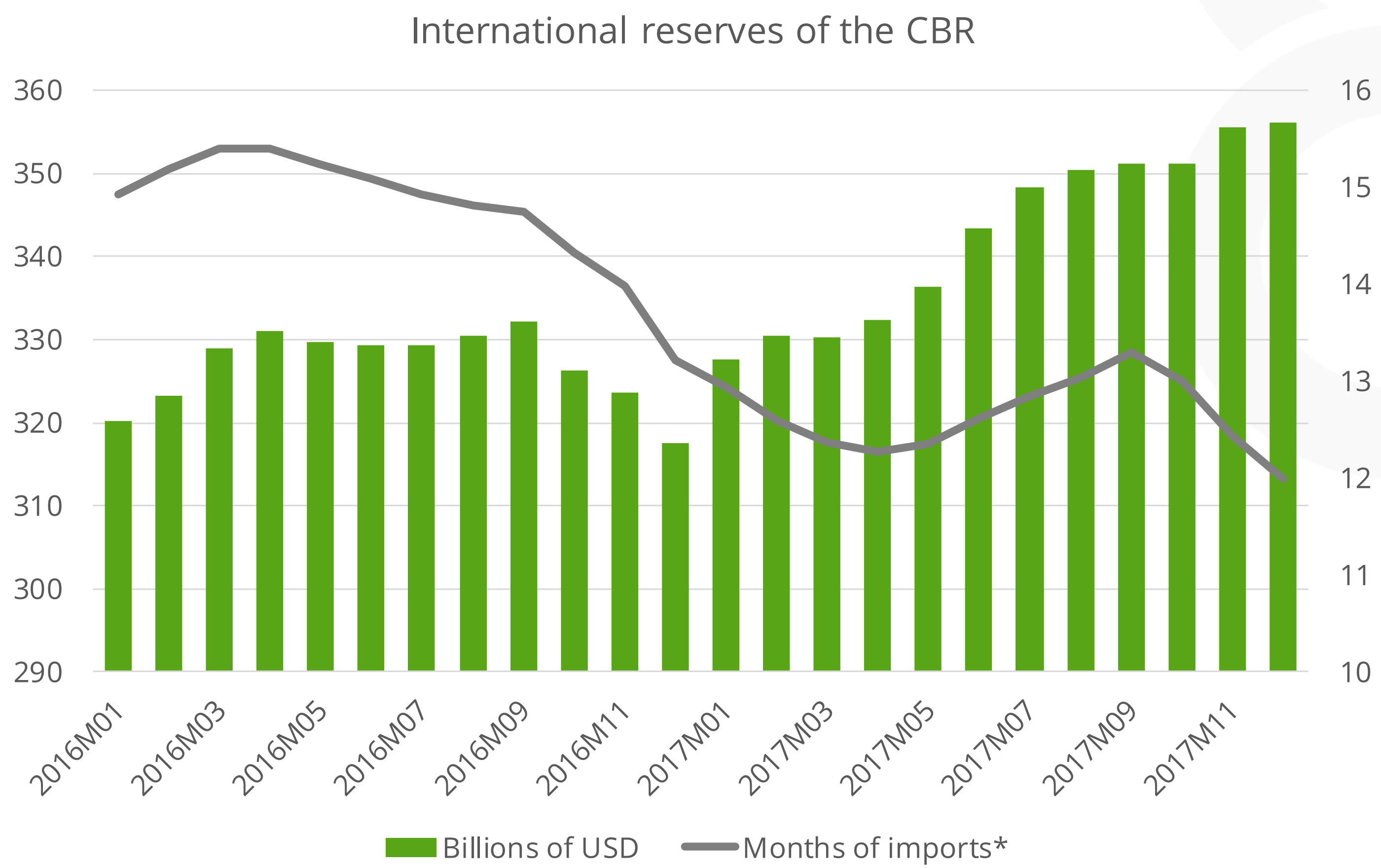

- The preliminary data for 2017Q4 shows brighter picture, suggesting a **jump to 4%** of GDP CA surplus from 2%, probably due to high oil prices.

# The outflow of financial resources remained muted




- Net effect of declining other investments and positive portfolio inflows: outflow of financial resources remained muted
- In 2017Q3 seen rising portfolio investments, partly due to investors' increasing appetite for Russian assets.

# Thus the positive CA balance helped FX reserves to accumulate further




* Based on BoP, prolonged with monthly growth rate

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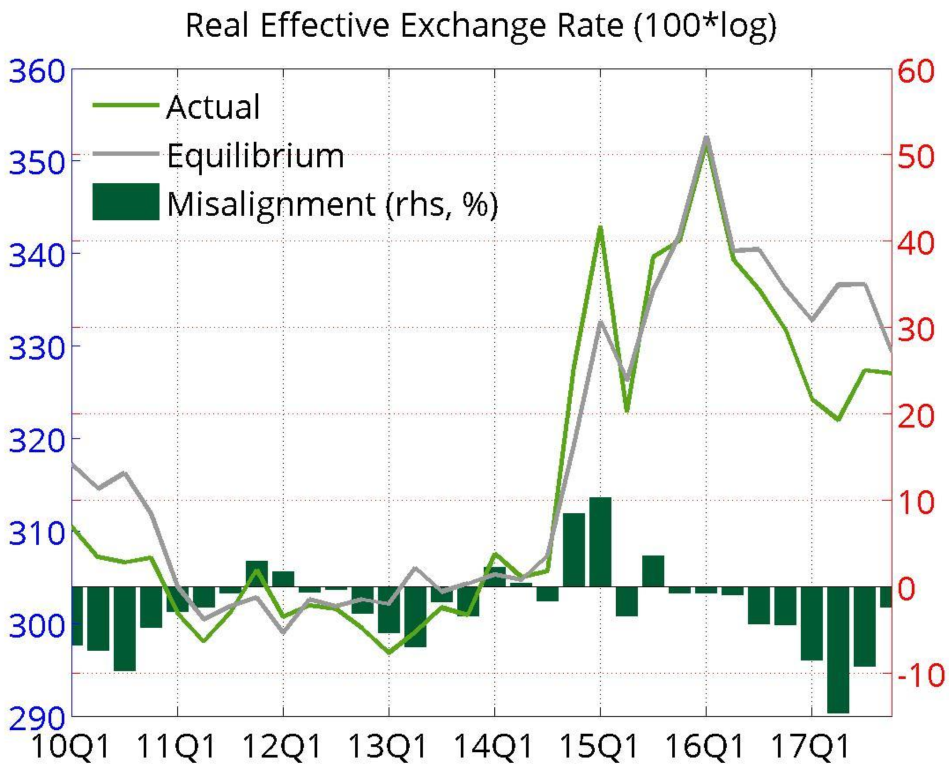
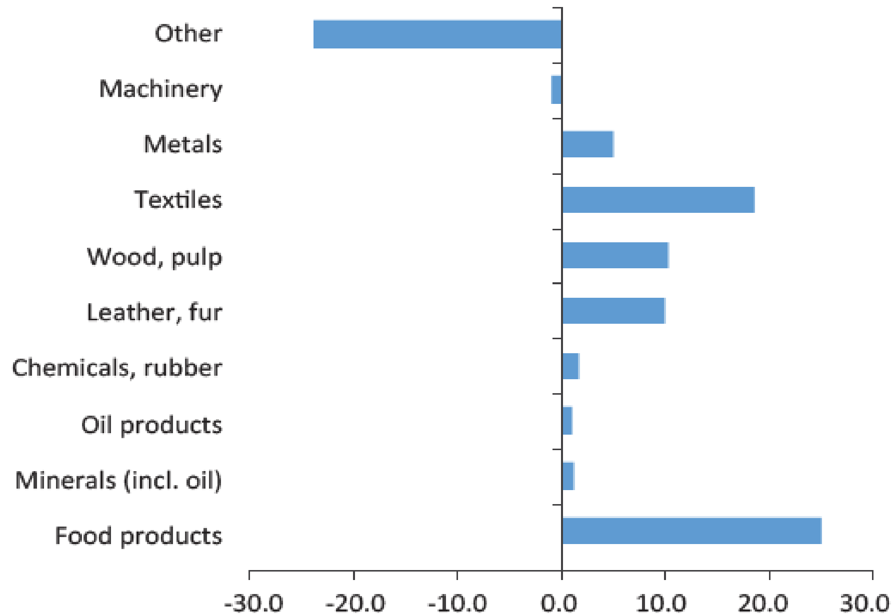
# Our BEER misalignment metric also suggests disappearing overvaluation…




- The behavioral equilibrium exchange rate (BEER) approach shows that the gap between the actual and equilibrium values of the REER is disappearing on the back of the increasing oil price.

# ...but real appreciation might further erode non-oil sector competitiveness

**YoY growth of real exports in 2017Q2**




*Source: World Bank Russia Economic Report, 2017 November*

- In 2017H1, real exports declined in *Machinery* and *Other* and remained close to flat in *Chemicals, rubber* sectors pointing to competitiveness problems in more complex industries

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# Inflation, Interest Rate and Exchange Rates

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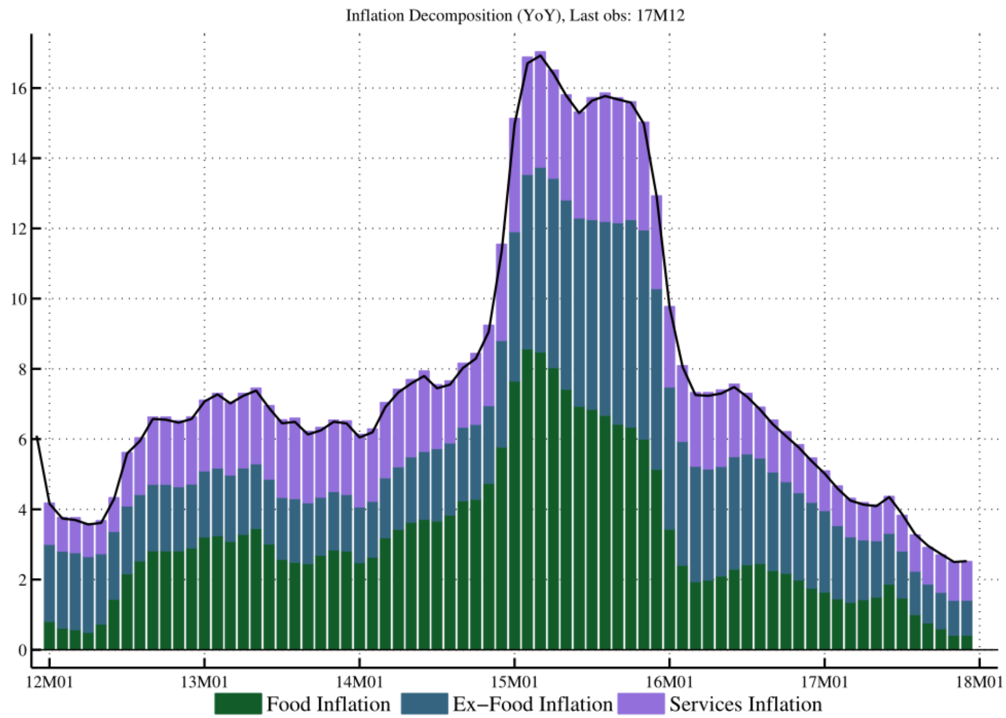
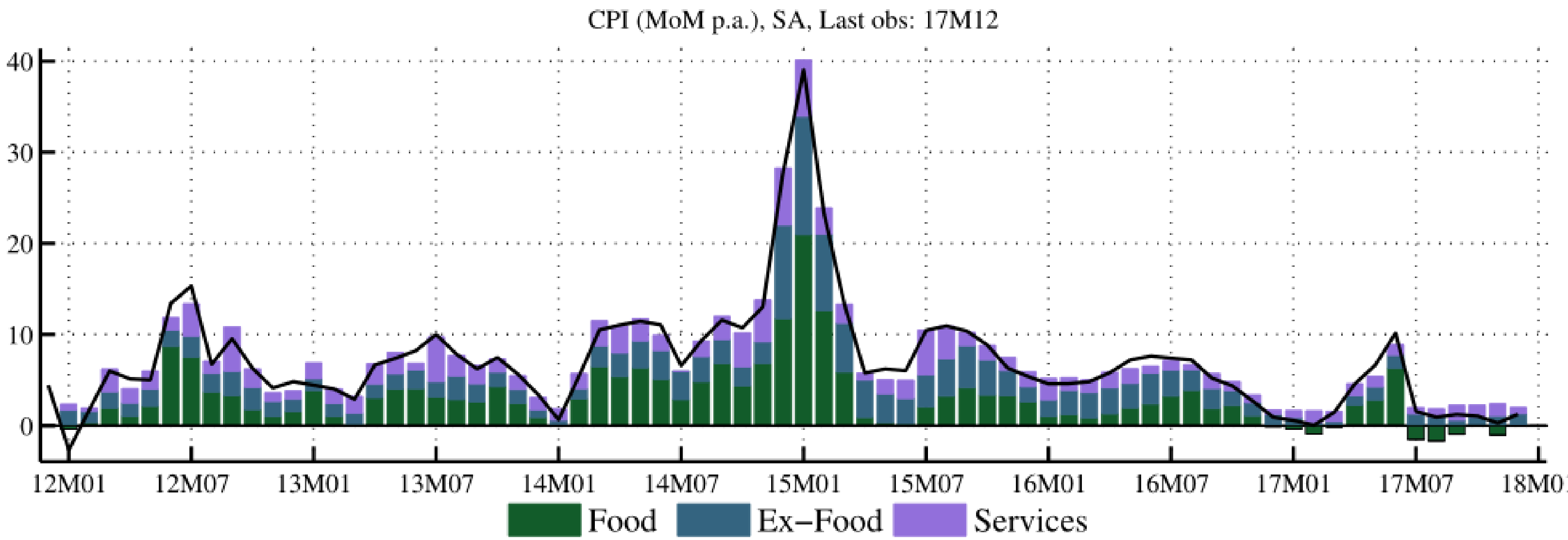
# YoY inflation fell way below target in 2017Q4 ...



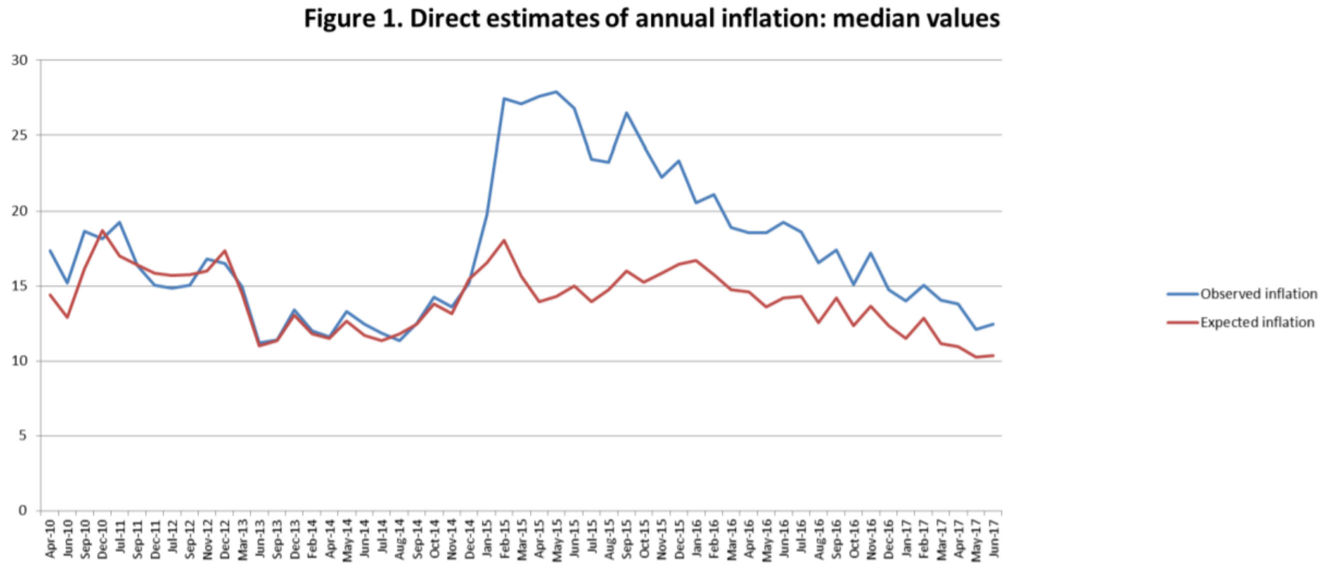

- YoY inflation halved in 2017 decreasing from 5.0% in January to under 2.5 % by December. 2018 January inflation expected at record lows of 2.3 percent to 2.5 percent.
- A still meagre domestic demand, relatively tight monetary policy and favorable food prices supported the slowing trend of price growth.

# … in line with muted MoM dynamics




- Food inflation decelerated significantly due to an expanded supply of crop products, base effects linked to the later harvesting period and specific one-off factors in the field vegetables market.
- Non-food prices also decelerated due to the negative output gap and tight monetary policy
- Services prices increased slightly on the back of transport prices

# CBR's survey indicates still high and slowly declining inflation expectations




*Source: CBR*

- Inflation expectations are still over 10% YoY, according to CBR's survey. The central bank pays special attention to inflation expectations in its communication.

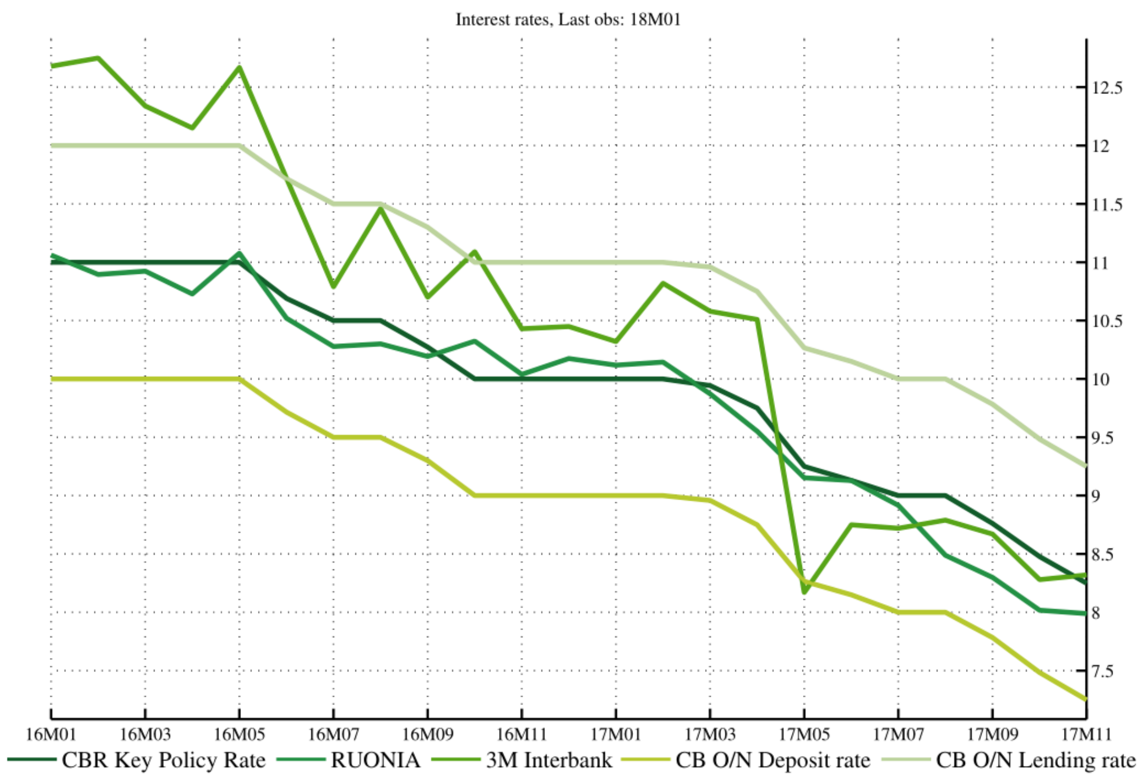
- *"The slowdown of inflation was conducive to a decline in inflation expectations, which nevertheless remains unstable and uneven."* – emphasized the CBR after its last interest rate decision.

# External forecasters expect inflation to be slightly below target this year

| CPI Inflation (avg., YoY, %) | 2018 | 2019 | 2020 |
|---|---|---|---|
| WB 201706 | 4.0 | 4.0 | - |
| IMF 201710 | 3.9 | 4.0 | 4.0 |
| OGR 201710 | 3.7 | 4.1 | 4.0 |
| CBR 201712 | 3.75 | 4.0 | 4.0 |
| EIU 201801 | 3.9 | 4.5 | 4.7 |
| Bloomberg 201801 | | 3.5 | 4.1 |

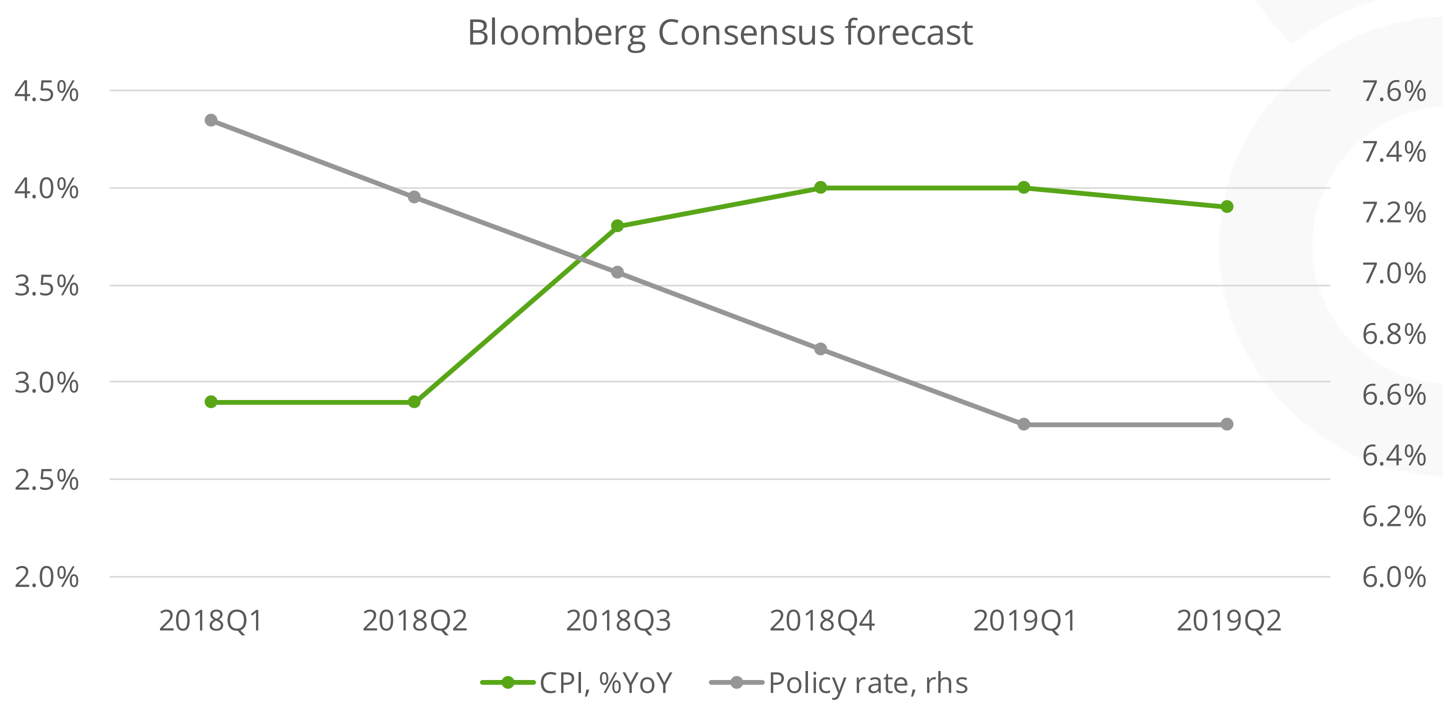
# Monetary Policy

# CBR has cut policy rate to 7.50%...




- The central bank referred to both the recent undershooting of inflation and pro-inflationary risks on the one-year horizon, suggesting a cautious approach in 2018.
- CBR assesses its monetary stance as moderately tight.

# The market consensus expects around 100 bps cuts in the policy rate in 2018




Source: Bloomberg Russia Survey, 2018 January

- The monetary policy is seemed credible as inflation is also expected to revert to target in few quarters

# Politics

# March 2018 elections: only legitimacy is at stake for President Putin

- President Putin announced running for a fourth term in January
- Given approval ratings above 80 percent, the only main challenge for Putin will be to prevent a sharp fall in turnout, which would throw doubt on the legitimacy
- To stimulate turnout but minimize the risk of real competition, the administration favors ‚fake' opposition candidates
- In December 2017, the Electoral Commission barred Aleksei Navalny, a true opposition figure from running, citing his corruption charges. At the same time the high-profile TV personality Ksenia Sobchak, daughter of President Putin's early mentor has become a candidate.

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# US does not introduce new sanctions for now, but risks remain high

- The new law adopted in last August authorized the Trump administration to possibly impose a range of additional sanctions
- On January 29, the White House had to deliver a list of Russia’s ‘most significant senior foreign political figures and oligarchs. However so far instead of serving as a basis of further sets of sanctions, the ‘Kremlin Report’ got ridiculed for being superficial (stated to be copied from Russian Forbes list), and no new sanctions were announced.
- Analysts deem this step as a gesture for Russia, but the future of new sanctions is still uncertain given the tensions between US administration and the Senate+Congress

# Risks

# Risks are tilted to the negative

- ***Effect of sanctions on business confidence***: tensions with the West are still high, the US Congress kept the door open to further measures that can harm numerous sectors.
- ***Banking sector woes***: the proportion of bad loans remains high, especially for smaller, privately owned „pocket banks". Although a full-blown financial crisis seems unlikely, managing a banking crisis would hijack resources from meaningful economic reforms.
- ***Path of oil price recovery***: Russian growth remain highly sensible to oil prices.
- ***Outcome of the March 2018 election***: although President Putin's victory is likely, a low voter turnout might undermine his legitimacy, making it more difficult to govern.

# Disclaimer



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