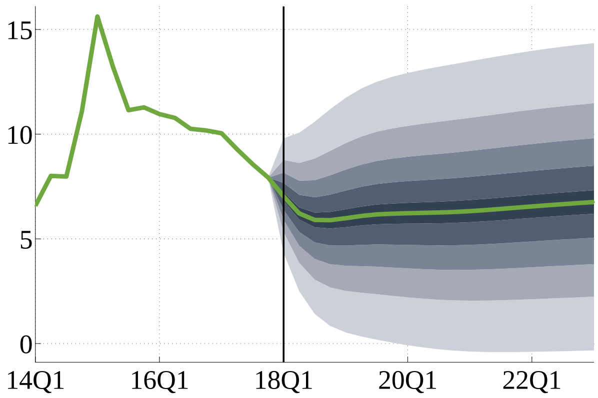
Russia

Macroeconomic Forecast – February 2018

OGResearch

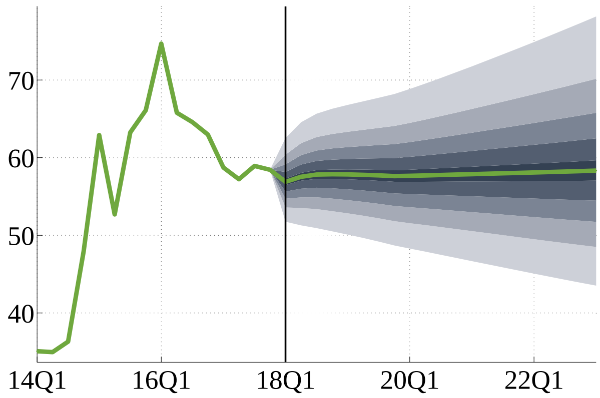
The central bank will continue cutting the policy rate on account of a favorable inflation outlook.

Overnight Interbank Interest Rate (percent, p.a.)



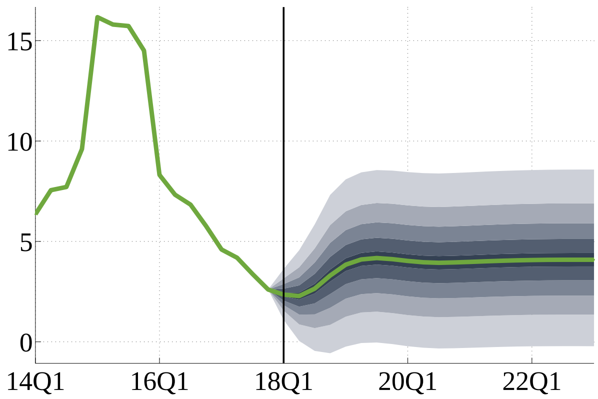
The nominal exchange rate will depreciate mildly in the medium-term as a result of inflation differential slightly being higher than the equilibrium real appreciation.

Nominal Exchange Rate (RUB per USD)



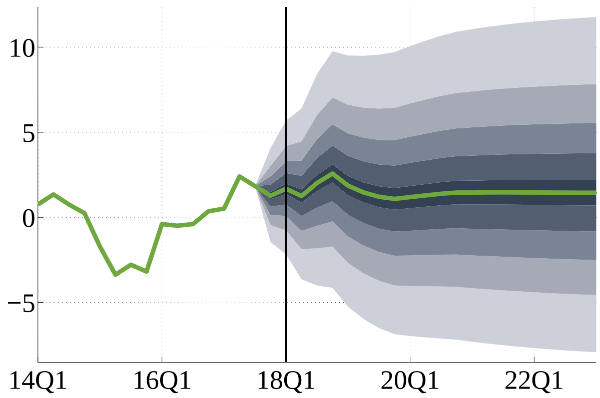
After undershooting in 2018, inflation will stabilize around the central bank's 4 % target.

CPI Inflation (percent, YoY)



The lack of economic diversification and banking sector problems keep the medium-term growth outlook contained.

Real GDP Growth (percent, YoY)



Grey bands represent 10, 30, 50, 70, and 90 % confidence intervals.

Source: OGResearch

The projections are based on the February 2018 macroeconomic forecast. For more information see www.macro.ogresearch.org.

Disclaimer

The information and opinions contained herein do not necessarily reflect OGResearch's views and OGResearch does not warrant the correctness thereof. This document is for informational purposes only, it is not intended as a solicitation or offer to enter into any transaction or business relationship, and should not be taken as advice or a recommendation to buy or sell any financial instruments or securities. OGResearch does not accept liability for any damage caused by reliance on the contents herein.

Russia

Macroeconomic Forecast – February 2018

OGResearch

Growth momentum has decelerated in 2017H2 as oil and gas production slowed considerably. We expect the economy to exhibit higher growth in the short run supported by improving terms of trade, with subdued medium-term growth potential.

The Russian economy has slowed down to 1.4 % YoY in 2017H2. Despite a bumper harvest, slowdown in the mining sector rendered primary sector growth flat. YoY growth in crude oil production turned negative from September due to a high basis stemming from an accelerated production in end-2016 before the OPEC agreement's production cut became effective[1], while the warm weather conditions slowed down gas production. In 2017Q4, industry slowed further as metallurgy and production of other vehicles exhibited a sharp fall, partly due to the slowing production levels and unused capacities in hydrocarbon production.

In December 2017, the central bank has taken over another privately owned credit institution, Promsvyazbank, at an estimated cost of USD 1.7-3.4 billion (0.1-0.2 % of GDP), the third such bank rescue in six months. As bailouts were partly triggered by the central bank's strengthened oversight, and also considering the relatively large value of sovereign assets at the authorities' disposal[2], we expect the banking sector to remain under control. Nevertheless, the high level of non-performing loans[3] remains a drag on growth.

Albeit we expect 2018 oil production to stay at 2017 levels, improving terms of trade and recovery in lending flows[4] and the strong ruble will support domestic demand. Therefore, growth outlook will slightly improve in the short term despite still tight monetary conditions and ongoing moderate fiscal consolidation[5] will constrain economic dynamics. We estimate medium-term growth of Russia at around 1.5 % due to competitiveness problems of the non-oil economy, constrained by weak rule of law, corruption and poor regulatory quality. This is broadly in line with the market consensus.

Given below-target inflation and the lack of price pressures, the central bank will continue its cautious easing cycle. The ruble will depreciate by around 0.5 % annually on the back of the inflation differential to the U.S., despite a slight real appreciation resulting from the better outlook for oil prices.

Headline inflation halved in 2017 and decreased further in 2018 January to 2.3 % YoY, well below the central bank's 4 % target. The deceleration was mainly driven by a significant drop in food prices on the back of a good harvest. Nonetheless, non-food and services prices have also remained subdued reflecting still weak demand, a relatively tight monetary policy and lack of significant administrative price hikes.

The central bank has cut the policy rate by 50 bp to 7.75 % in mid-December and a further 25 bp in February on the back below-target inflation and a lack of price pressures. Albeit domestic

[1] Russia has implemented the promised 300,000 barrels per day cut by April 2017.

[2] Reserve assets in the two Russian sovereign wealth funds stood above 5 % of GDP in 2017Q4.

[3] Estimates of non-performing loans range between 5.4 % and 8 % of total loans, and official statistics indicate that the ratio reached a plateau in 2016. However, unofficial sources suggest the problem could be worse.

[4] We foresee around 20 % higher average annual oil price for 2018 than in 2017. As the surge is associated partly with geopolitical uncertainties in the Middle East, the longer-term outlook is highly uncertain and our trend growth rate projection for oil price was only revised upwards moderately.

[5] Following the better-than-expected 2017 budget deficit of 1.6 % on the back of higher revenues, the 2018 deficit target is set at 1.3 %, and the 2019 deficit target to 0.9 %.

demand is still weak and underlying inflation measures are low, we expect the CBR to remain cautious in its future actions. This ensures that inflation expectations remain anchored comfortably at the medium-term target. Additionally, the CBR seems to make sure that the interest rate differential compared to US remains high enough to compensate for investors' increased concerns over Russia, mostly in light of lingering new US sanctions. Hence, although the CBR is expected to continue loosening monetary conditions throughout 2018, the monetary stance will remain relatively tight until 2018Q4.

Annual nominal depreciation of around 0.5 % is foreseen in the medium-term as a result of the opposing dynamics of the inflation differential with the US on the one hand, and by real appreciation on the account of the increase in real oil prices on the other. We expect the new fiscal rule to weaken the effect of oil price volatility on the ruble exchange rate to the dollar.

The risks are high and tilted to the negative.

Although we evaluate that the publication of the 'Kremlin Report' without announcing new sanctions[6] means less pressure from the US on Russia compared to expectations, the U.S. Congress seems dissatisfied with the administration's approach and pushes for further measures that can harm numerous sectors[7] leading to weaker exchange rate and higher yields. 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. Such a scenario could increase yields and weaken the exchange rate again.

While President Putin's victory is likely on the March 2018 elections, a low voter turnout might undermine his legitimacy, making it more difficult to govern effectively and harming economic potential. In addition, Russian growth remains highly sensible to oil prices both on the positive and negative side - a symmetric risk to the forecast.

[6] In January 2018, the White House had to deliver a list of Russia's 'most significant senior foreign political figures and oligarchs' as potential targets for further sanctions. However, so far the 'Kremlin Report' got ridiculed for being too broad and superficial (stated to be copied from Russian Forbes list), and no new sanctions were announced.

[7] The US Congress passed a law in July tightening restrictions on lending to certain state-owned banks and energy companies and barring the president from relaxing sanctions without approval from the legislative body. The law also authorizes the Trump administration to impose a range of additional sanctions against companies involved in pipeline development in Russia and against state companies in the railway, metal, and mining industries.

Baseline

		17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1
Nominal Interest Rate																										
Overnight Interbank Rate	percent p.a.	10.0	9.3	8.6	7.9	7.0	6.2	5.9	5.9	6.0	6.1	6.2	6.2	6.2	6.2	6.3	6.3	6.3	6.4	6.4	6.5	6.5	6.6	6.7	6.7	6.8
Nominal Exchange Rate																										
RUB per USD	level	58.73	57.22	58.94	58.44	56.89	57.54	57.83	57.87	57.85	57.79	57.72	57.63	57.66	57.72	57.77	57.82	57.88	57.93	57.99	58.04	58.10	58.15	58.21	58.27	58.34
	percent, YoY	−21.4	−13.0	−8.7	−7.2	−3.1	0.6	−1.9	−1.0	1.7	0.4	−0.2	−0.4	−0.3	−0.1	0.1	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
	percent, QoQ @ar	−27.0	−10.3	12.0	−3.4	−10.6	4.6	2.0	0.3	−0.1	−0.4	−0.5	−0.6	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Inflation																										
CPI	percent, YoY	4.6	4.2	3.4	2.6	2.4	2.3	2.6	3.3	3.8	4.1	4.2	4.1	4.0	4.0	3.9	4.0	4.0	4.0	4.0	4.1	4.1	4.1	4.1	4.1	4.1
	percent, QoQ @ar	3.1	3.4	2.3	1.5	2.1	3.1	3.7	4.1	4.2	4.1	4.0	3.9	3.9	3.9	3.9	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
CPI Inflation Target	percent YoY	6.2	6.0	5.8	5.7	5.5	5.2	5.0	4.8	4.6	4.4	4.2	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Real GDP																										
Real GDP Growth	percent, YoY	0.5	2.4	1.8	1.3	1.7	1.3	2.0	2.6	1.9	1.5	1.2	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.4	1.4
	percent, QoQ @ar	2.2	4.3	−1.0	−0.5	3.9	2.6	2.1	1.7	1.1	1.0	1.0	1.2	1.5	1.4	1.4	1.5	1.5	1.5	1.5	1.4	1.4	1.4	1.4	1.4	1.4
Output Gap	percent	−1.2	−0.3	−0.8	−1.1	−0.4	−0.0	0.2	0.3	0.2	0.1	0.1	−0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign Gap	percent	−0.3	−0.0	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.0	0.0	−0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real Interest Rate																										
Real Interest Rate	percent p.a.	5.6	5.0	5.1	5.2	4.5	3.4	2.5	1.9	1.8	1.8	1.9	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.4	2.4	2.5	2.5
Trend	percent p.a.	1.7	1.8	2.0	1.5	1.6	1.7	1.9	2.0	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.3	2.3	2.4	2.4	2.5	2.5	2.6	2.6	2.6
Gap	percent	3.9	3.2	3.1	3.7	2.9	1.7	0.6	−0.1	−0.3	−0.3	−0.2	−0.1	−0.1	−0.0	−0.0	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1
Real Exchange Rate																										
Real Exchange Rate	percent, YoY	−27.7	−17.4	−8.7	−4.7	2.0	5.1	−0.2	−0.2	0.0	−1.4	−2.0	−2.2	−2.0	−1.7	−1.5	−1.3	−1.2	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3
	percent, QoQ @ar	−30.0	−8.9	21.6	−1.6	−3.0	3.4	0.4	−1.6	−2.1	−2.2	−2.2	−2.2	−1.4	−1.2	−1.2	−1.2	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3	−1.3	−1.2
Trend	percent, YoY	−0.5	−1.0	−1.5	−2.0	−2.4	−2.6	−2.7	−2.6	−2.5	−2.4	−2.3	−2.2	−2.1	−2.0	−1.9	−1.8	−1.7	−1.7	−1.6	−1.5	−1.5	−1.4	−1.4	−1.3	−1.3
Gap	percent	−7.7	−9.4	−3.5	−3.2	−3.2	−1.7	−1.0	−0.8	−0.7	−0.7	−0.8	−0.8	−0.7	−0.5	−0.4	−0.2	−0.2	−0.1	−0.0	−0.0	−0.0	0.0	0.0	0.0	0.0
FPAS UIP Premium	percentage point	3.0	3.4	4.0	4.0	4.0	4.0	4.0	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3	3.2	3.1	3.1	3.1	3.0	3.0	3.0	3.0	3.0	3.0

Forecasts Comparison

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1
Overnight Interbank Interest Rate (percent p.a.)																									
February 2018, Full Fcast	10.0	9.3	8.6	7.9	7.0	6.2	5.9	5.9	6.0	6.1	6.2	6.2	6.2	6.2	6.3	6.3	6.3	6.4	6.4	6.5	6.5	6.6	6.7	6.7	6.8
October 2017, Full Fcast	10.0	9.3	8.6	8.1	7.2	6.6	6.3	6.1	6.1	6.0	6.1	6.1	6.1	6.2	6.2	6.3	6.4	6.5	6.6	6.6	6.7	6.7	6.8	6.8	· · ·
Nominal Exchange Rate (RUB per USD)																									
February 2018, Full Fcast	58.73	57.22	58.94	58.44	56.89	57.54	57.83	57.87	57.85	57.79	57.72	57.63	57.66	57.72	57.77	57.82	57.88	57.93	57.99	58.04	58.10	58.15	58.21	58.27	58.34
October 2017, Full Fcast	58.73	57.22	58.94	58.77	59.16	59.64	59.96	60.19	60.41	60.56	60.66	60.69	60.80	60.92	61.02	61.10	61.17	61.23	61.30	61.37	61.44	61.52	61.60	61.68	· · ·
Nominal Exchange Rate (percent, QoQ)																									
February 2018, Full Fcast	−27.0	−10.3	12.0	−3.4	−10.6	4.6	2.0	0.3	−0.1	−0.4	−0.5	−0.6	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
October 2017, Full Fcast	−27.0	−10.3	12.0	−1.1	2.6	3.3	2.2	1.5	1.4	1.0	0.6	0.2	0.7	0.8	0.7	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.5	· · ·
Nominal Exchange Rate (percent, YoY)																									
February 2018, Full Fcast	−21.4	−13.0	−8.7	−7.2	−3.1	0.6	−1.9	−1.0	1.7	0.4	−0.2	−0.4	−0.3	−0.1	0.1	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
October 2017, Full Fcast	−21.4	−13.0	−8.7	−6.7	0.7	4.2	1.7	2.4	2.1	1.6	1.2	0.8	0.7	0.6	0.6	0.7	0.6	0.5	0.5	0.4	0.4	0.5	0.5	0.5	· · ·
CPI Inflation (percent, YoY)																									
February 2018, Full Fcast	4.6	4.2	3.4	2.6	2.4	2.3	2.6	3.3	3.8	4.1	4.2	4.1	4.0	4.0	3.9	4.0	4.0	4.0	4.0	4.1	4.1	4.1	4.1	4.1	4.1
October 2017, Full Fcast	4.6	4.2	3.6	3.4	3.5	3.5	3.7	3.9	4.0	4.1	4.1	4.1	4.0	4.0	4.0	4.0	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	· · ·
Real GDP Growth (percent, YoY)																									
February 2018, Full Fcast	0.5	2.4	1.8	1.3	1.7	1.3	2.0	2.6	1.9	1.5	1.2	1.1	1.2	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.4	1.4
October 2017, Full Fcast	0.5	2.5	2.3	2.4	2.0	1.1	1.5	1.4	1.5	1.4	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.4	1.4	1.4	1.4	1.4	1.4	1.4	· · ·