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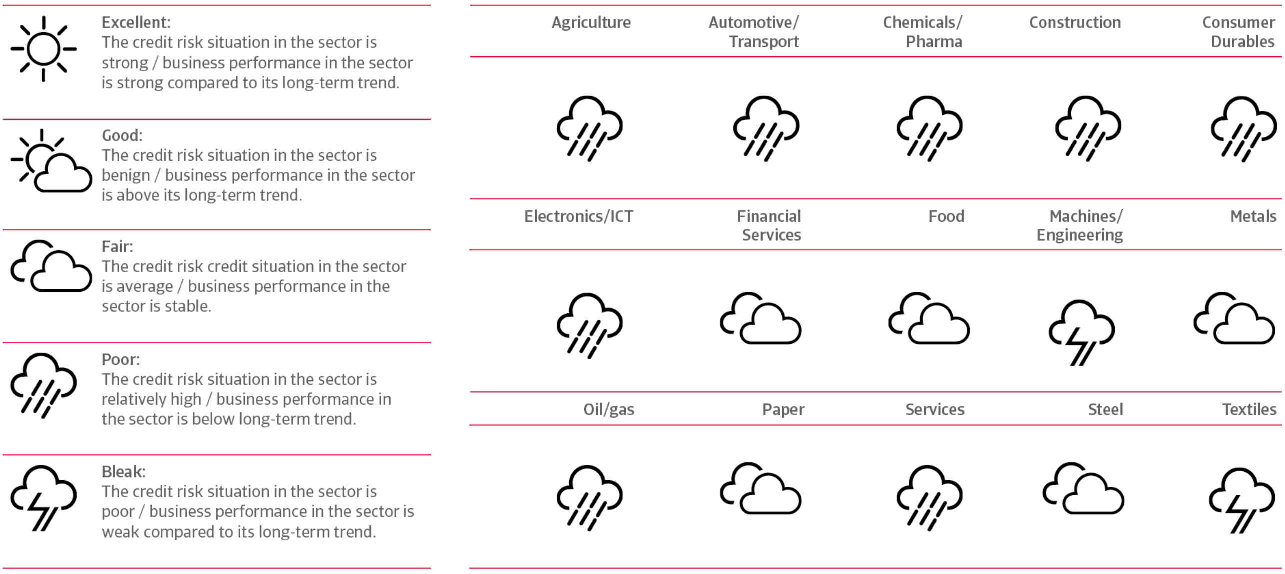
Russia Country Report

August 2020

The economic situation remains strained

Russia industries performance forecast

August 2020



Political Situation

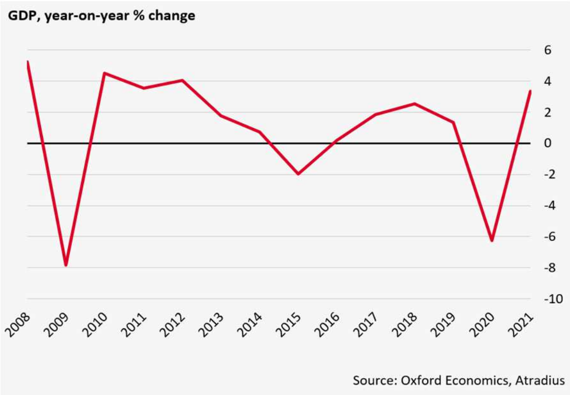
EU and US tensions with Russia remain prominent

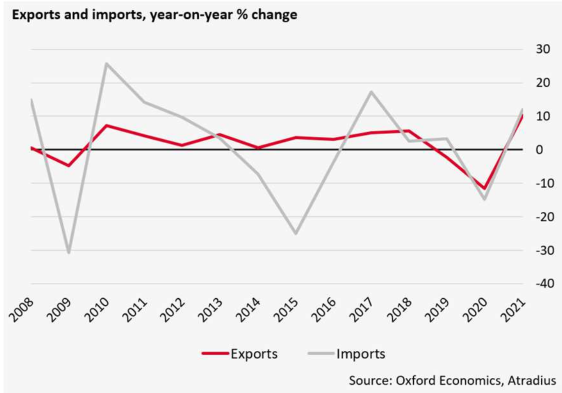
In a referendum held in June 2020, several constitutional reforms were approved with 78% majority of the votes. The reforms include an amendment that allows President Vladimir Putin to run again for presidency in 2024 and allows him to serve two more six-year terms.

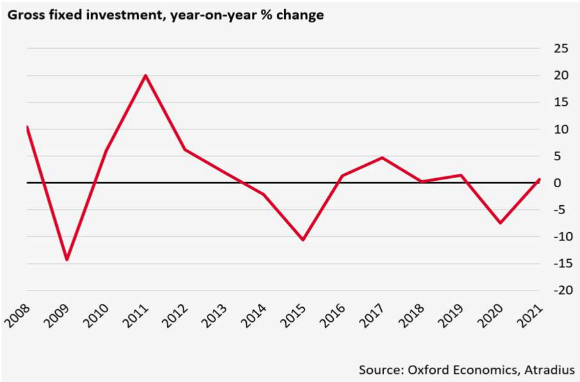
Since the outbreak of the Ukraine crisis in early 2014, Russia's relationship with the EU and US has deteriorated. Russia´s intervention in the civil war in Syria added another area of conflict to the already strained relationships. Moscow´s annexation of Crimea in March 2014, its tacit support of separatist forces in Eastern Ukraine, and secret service activities in Europe triggered several rounds of sanctions from the EU and the US (frozen assets, travel bans on several individuals, financing limitations restricting access to EU/US capital markets, restrictions on the export of certain types of high-tech products to Russia).

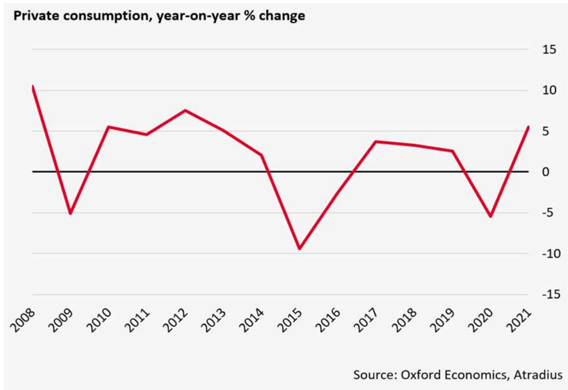
There is little prospect for an improvement in Russia´s relationship with the EU and the US in the short-term. The US has implemented additional sanctions in 2019 and is likely to expand more sanctions on the Nord Stream 2 project in 2020.

Economic Situation









The economy is under strain due to low oil prices and bleak global growth prospects

After growing just 1.3% in 2019, the Russian economy is expected to contract 6.3% in 2020, due to a double blow from social distancing measures and the global oil price shock. In 2021, a 3.3% rebound is forecast.

Physical distancing measures have been gradually eased since mid-May after a seven-week lockdown period. However, private consumption is still expected to contract by more than 5% in 2020, while investment will decrease by more than 13%. Both the lower oil price and decreased demand for oil will hit the Russian economy hard (oil and gas exports account for 55% of total exports and about 40% of federal government revenues). Exports are expected to contract by more than 11% in 2020 as a result of oil production cuts, while imports are expected to decline by 23%, as domestic demand decreases and the government retains its import substitution policy.

After a price war for market share between Saudi Arabia and Russia had led to a sharp decrease of the oil price to below USD 20 per barrel, in April 2020 the OPEC cartel members and Russia agreed to reduce production by 9.7 million barrels a day. As a result of this agreement, Russia is expected to lose USD 150-160 billion in export revenue in 2020. According to the US Energy Information Administration (EIA), the average per barrel oil price will be USD 40.50 in 2020, which is below the USD 45 price Russia requires for long-term fiscal sustainability.

Fiscal and monetary measures to support the economy

In order to combat the recession, both the government and the Central Bank have announced a range of measures to support affected businesses and households. In early June 2020 the government approved additional fiscal measures worth RUB 5 trillion (USD 72 billion), on top of a first USD 40 million stimulus package announced in March. Russia's budget balance will reverse from a surplus of 2.2% of GDP in 2019 to a 5.2% of GDP deficit in 2020, due to the low oil price, weak local economic activity and tax-relief measures. In particular, the low oil price will eat into Russia's budget, with related revenues expected to decrease by about 20%. However, the weaker rouble exchange rate will offset a steeper decline.

The Russian rouble depreciated 23% against the USD in January-March 2020, to RUB 80 against USD 1, but has regained some of its value since then. This rebound has been due to Central Bank´s and Ministry of Finance's foreign-currency sales that supported the currency, but also amid Russia's robust fiscal backdrop and real positive yields, making Russian assets attractive to foreign investors. It is expected that the rouble will trade at an average of 71 against USD 1 in 2020, a 9.2% depreciation compared to 2019. The rouble's rebound from its weakness has allowed the Central Bank of Russia to implement several rate cuts in order to support the economy, from 6.25% in early 2020 to 4.5% in June. Additional rate cuts are expected, as the Central Bank is more worried about inflation slowing too far below its 4% target than moving above it.

Foreign debt is expected to increase from 26% of GDP in 2019 to 34% of GDP in 2020, but to decrease again in the coming years. Projections show that external debt is rather robust against macro-economic shocks. While foreign exchange reserves are expected to decrease from USD 443 billion in 2019 to USD 399 billion in 2020, they remain high at 22 months of import cover.

The Russian banking sector is coming under pressure due to the economic downturn, which is weighing heavily on profitability and asset quality. The non-performing loan ratio is high at 9.4%, and will probably rise further as households and corporates face increasing difficulties in servicing their debts. However, the capital adequacy ratio of 12.7% is sufficiently high for banks to be able to withstand financial stresses.

Major structural weaknesses weigh on growth prospects

The medium-term prospect for higher and sustainable growth rates remains subdued. International sanctions will depress foreign direct investment inflows in the coming years. Structural weaknesses (such as a shrinking workforce, dependency on natural-resource sectors, institutional weaknesses, poor productivity growth and a difficult business environment will continue to weigh on growth.

The Russian business climate is mired in uncertainty regarding property rights, a weak transport infrastructure and a lack of competition in goods and services markets. There is an underlying deterrent for investments, badly needed to modernise the energy sector and to help diversify the economy. Even before the outbreak of the Ukrainian crisis, the investment level was too low and foreign direct investment too limited, partly due to an unfriendly business climate and the firm grip of the state on large parts of the economy. This is now exacerbated by the international sanctions imposed by the EU and the US that aim to prevent technology transfers and financing to Russian firms, especially in the energy and military sectors.