

4. MANAGEMENT REPORT

RUSSIAN ECONOMY AND BANKING SECTOR

Russian Economy in 2018

In 2018, Russian economic growth accelerated to 2.3% year-on-year from of 1.6% in 2017. The structure of growth from the demand perspective was shaped by the MinFin's fiscal rule¹, that prevented the increase in oil prices to spill over to the appreciation of the real effective exchange rate (REER): in 2018 the REER declined by 7.7%.

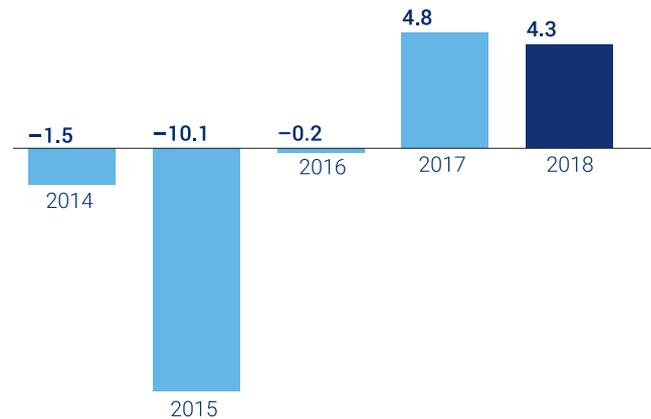
As a result, import growth totaled just 3.8%, while exports expanded 6.3% in 2018. In addition, economic growth was supported by household demand expanding 2.2% and gross fixed capital formation, which increased 2.3%.

Russian macroeconomic indicators, % change year-on-year

Gross domestic product



Investments in fixed assets



Industrial production



Retail turnover



1. According to the new fiscal rule that came into effect in the Russian Federation in 2018, all oil and gas revenues generated by oil prices above the budget benchmark level are used by MinFin for currency purchase and its allocation in the National Wealth Fund (NWF). The 2018 budget was based on a Urals oil price of USD 40 per barrel with 2% indexation annually going forward.

Oil price^{USD} and exchange rates^{RUB bn}



Household demand continued to enjoy the support of robust real wage growth and the expansion of retail lending. Real wages were up 7.0% (vs. 3.5% in 2017); however, their growth was not even throughout the year: it peaked at 11% in January on the back of low inflation and material acceleration of nominal wage growth, but has decelerated to 2.9% by year end of 2018.

Consumer confidence path matched that of the real wages: elevated in the first half of 2018, but dropped again in the second half of 2018 with gradual pick up in inflation and deceleration of the growth. In 2018, retail sales growth expanded 2.6%, with more visible growth in the non-food segment, while food turnover grew 1.7%.

According to a survey by the Bank of Russia, lending conditions for borrowers also eased in the first half of 2018, but tightened towards the year end of 2018.

From the production perspective, biggest contribution to headline GDP growth rate of 2.3% came from the mining sector (+0.44 pp), retail and wholesale trade (+0.28 pp), while increase in construction added around 0.25 pp. In terms of growth rates, not corrected by the relative sizes of the sectors, then the largest expansion was seen in the financial sector (+6.3%) as lending to households and corporates increased. The HoReCa sector was a close second (+6.1%), due to the 2018 World Cup being held in Russia, while construction (+4.7%) trailed in third place.

Consumer price growth has gradually picked up from 2.5% in December 2017 to 4.3% in December 2018. The turnaround in the price growth trends was to a large extent a function of the local and global harvest, FX pass-through and changes in the tax system. In particular, food category contributed 1.4 pp of the overall 1.8 pp price growth acceleration, while the remainder has been due to higher inflation in core goods and services.

In 2018, the Bank of Russia twice cut its key rate by 0.25 pp and then raised it twice by the same amount, leaving it at 7.75% by the year-end.

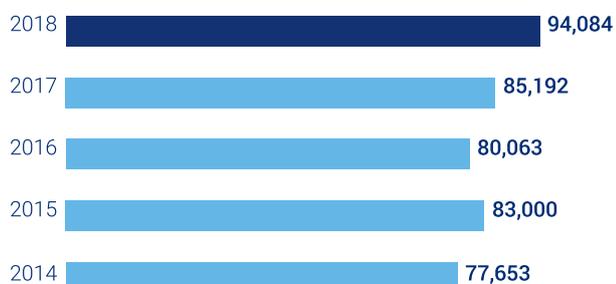
Currently, the Bank of Russia is focused on containing short-term inflation risks stemming from external shocks and change in the VAT base rate.

Inflation and Bank of Russia key rate



Russian banking sector in 2018

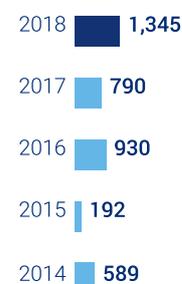
Assets, RUB bn



Equity, RUB bn



Net profit, RUB bn



In 2018, Russian banking sector assets increased by 10.4%, compared to growth of 6.4% a year earlier. The penetration of banking services, defined as a banks' total assets divided by GDP, increased by 1.6 pp to 94%.

In the first half of 2018, banks reduced interest rates on loans following a decrease in the key rate, which contributed to an increase in demand for borrowing. The increase in interest rates in the second half of the year did not, however, have a significant impact on the growth rate of the loan portfolio. As a result, the acceleration of growth in the retail loan portfolio (up to 22.4% in 2018 from 12.7% in 2017) due to high growth rates in mortgage and consumer lending (23.3% in 2018 and 21.1% in 2017, respectively), as well as the resumption of growth in the corporate loan portfolio (12.0% in 2018 compared to an increase of 2.2% a year earlier) ensured steady growth in lending of 14.7% in 2018 (4.7% in 2017). According to the Bank of Russia, excluding the depreciation of the rouble against the US dollar in 2018 and the effect associated with the revocation of the licences of a number of credit institutions, the corporate loan portfolio grew by 5.8% and the retail loan portfolio by 22.8% in 2018.

In 2018, the share of overdue loans in the retail portfolio decreased to 5.1% and in the corporate portfolio to 6.3%. The loan loss provision ratio decreased to 8.3%, but the coverage ratio rose to 177%.

The weakening of the rouble had a noticeable impact on the growth of deposits and accounts. Corporate accounts increased by 16.4% in 2018 (compared to a 7.4% increase in 2017), while term deposits were up by 9.5% in 2018 (compared to 7.4% in 2017), accounting for 71% of banks' liabilities. During the year, the net loans-to-deposits ratio decreased by 1.3 pp to 72%. Banking sector debt to the Bank of Russia increased by 29% in 2018, reaching 3.1% of assets.

Banks' profits increased by 70.3% during the reporting period to RUB 1.3 trillion. The number of unprofitable credit institutions decreased from 140 at the end of 2017 to 100 in 2018. Growing profits contributed to an increase in return on equity in 2018, which rose by 6 pp to 15.1%, and an increase in capital adequacy (during the 12 months of 2018, the total capital adequacy ratio (N 1.0) increased by 10 bp to 12.2%).

Russian banking sector, RUB bn

Loans to legal entities



Loans to individuals



Deposits and accounts of legal entities



Deposits and accounts of individuals

