28 March 2019

Russia

Postcard from Moscow – strong macro policy framework amid external risks

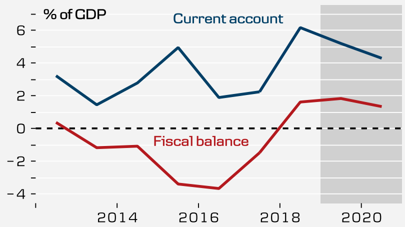
- **Postcard from Moscow.** We recently had the opportunity to visit Moscow, where we met with different policymakers and observers. This document provides our key observations from the trip.
- **Macroeconomic policy framework.** The authorities have put in place a strong set of macroeconomic policies on both the fiscal and monetary side, including ambitious fiscal rule and pension reform.
- **Growth outlook.** Russia is set to struggle to achieve the ambitious growth targets set out in the six-year presidential programme, with a risk that failure to achieve the targets will increase pressure to relax the fiscal rule even further.
- **Sanction risk and impact.** We believe further tightening of the US sanction regime is likely but these sanctions may hit the Russian economy by less than perceived.
- **Political outlook.** Most expect Vladimir Putin to step down as leader in 2024, although remaining active behind the scenes. He is likely to select his own successor to ensure a smooth transition but there are no current clear favourites.
- **RUB outlook.** Despite the Mueller report playing down Russia's involvement in the US election and strong macroeconomic fundamentals, we remain a bit bearish on the RUB given the ongoing risk of further US sanctions, seeing USD/RUB 66.10 in 1M, 68.20 in 3M, 70.00 in 6M and 71.00 in 12M.

A very prudent macroeconomic policy framework

The Russian authorities have adopted a sound macroeconomic framework in recent years. In general, they came across as highly competent and prudent with a very good grip on the macroeconomic issues. Together with inflation targeting, we believe the fiscal rule adopted in recent years will help promote macroeconomic stability and avoid the economy suffering from Dutch disease problems. In a way, the new setup resembles the Norwegian oil setup, targeting accumulating any excess fiscal savings beyond an oil price of USD40 per barrel. The rule sets a target for structural primary balance at an oil price of USD40 per barrel. The only difference is the conversion of oil receipts into local currency, which requires open market operations to sterilise the monetary impact, while in Norway they spend only the return of the oil wealth fund. The IMF projects in the 2018 article IV consultation report that the oil fund is set to increase from 8% of GDP in 2018 to 20% of GDP in 2023 due to the fiscal rule.

One of the key objectives of the fiscal rule is to insulate the economy from large macroeconomic instability related to Dutch disease problems of higher oil receipts. For example, 15 years ago, the Russian manufacturing sector was quite competitive internationally, when the oil price was only c.USD40-50 per barrel, with a large part of investments flowing into the manufacturing sector. However, the subsequent surge in oil prices and investments prompted a significant rise in cost-based inflation, causing competitiveness to decline. Hence, the authorities attached great importance to the link between the fiscal side and the external side. In the rule, the accumulation of foreign assets is sterilised by higher fiscal surplus.

Significant improvement in Russia's macroeconomic balances since the crisis



Source: Macrobond Financial, Danske Bank

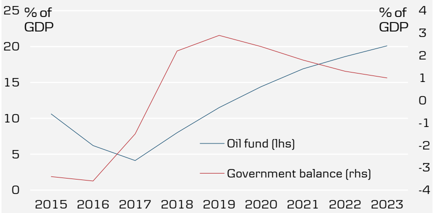
Chief Analyst & Head of Emerging Market & International Macro Research
Jakob Ekholdt Christensen
+45 45 12 85 30
jakc@danskebank.dk

Over the past four years, the authorities have undertaken a sizeable fiscal consolidation following the slump in oil prices. The size of the consolidation has reached 4 percentage points of GDP. The fiscal consolidation is now complete as the past year's structural primary fiscal balance is estimated to have reached 0.7% of GDP. **The main part of consolidation has come from improvement in revenue collection** by improving digitalisation of revenue. In this regard, the VAT gap reduced to a low level. Out of 3.5% of GDP consolidation, the authorities estimate 2.5% of GDP is due to revenue collection improvement in both the VAT and customs system. Another significant scope for additional revenue generation is improving PIT collection from implementing online cash registers. Such efforts could probably raise 1-2% of GDP in revenues.

The fiscal rule has been relaxed slightly to accommodate the six years' presidential programme. However, the easing increases the structural primary deficit only to 0.5 percent of GDP over the programme period. The fiscal easing should allow more spending on improving infrastructure, health and education. In addition, VAT rates have increased this year. With regard to pension reform, savings remain in the pension system to ensure pensions increase in line with wage growth.

Moody's just upgraded Russia, which means the country now has a 'BBB-' rating with all three major rating agencies. This rating appears to us to be on the low side given the strong macroeconomic fundamentals but may reflect the risk of sanctions.

IMF expects Russia to replenish its oil fund due to the fiscal rule



Source: Macrobond Financial, Danske Bank

Central bank—the careful guardian of macroeconomic stability

One of the most extraordinary achievements in recent years has been the central bank's ability to contain inflation pressure. In the past half year, inflation pressure has re-emerged with the weakening of the RUB in 2018 and the VAT hike early in 2019. However, the stable RUB has helped contain this inflation pressure, with the inflation data in February suggesting that the inflation rate on a month-on-month annualised basis already around 4%. In our view, inflation is set to top in March or April, after which we expect it to decelerate gradually, finding further momentum in the second half of 2019. However, the central bank would like to see a decline in inflation expectations, which we expect to happen only gradually. Therefore, we expect the easing of monetary policy to take place in the latter half of 2019. Following the monetary policy meeting on 22 March 2019, we think the Bank of Russia has left the door wide open for a cut as early as H2 19, shifting its guidance from 2020.

Central bank remains vigilant in fighting inflation

Source: Macrobond Financial, Danske Bank

In terms of the neutral rate, it is estimated at around 2-3% in real terms, consistent with 6-7% in nominal terms. This implies that with the current rate of 7.75%, monetary policy is contractionary, which makes sense with inflation above the central bank's target. This is consistent with a long-term US real rate of 1%, with the difference between the Russian and US real rates being the risk premium, which would lie somewhere around the CDS spread of 180bp.

Global developments clearly have an impact on the monetary policy outlook for Russia. On the challenging side for Russia's external outlook is the weakening momentum in the global economy, which is likely to affect Russian exports negatively. On the good side, the more dovish statements from the Fed and ECB and monetary policy stimulus in China made life easier for the Russian central bank by improving risk sentiment on emerging markets and aiding the RUB.

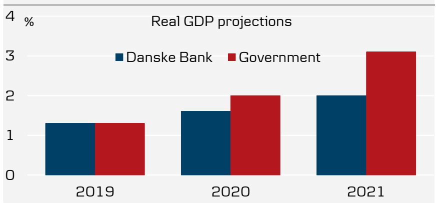
RUB has decoupled

Source: Macrobond Financial, Danske Bank

Unrealistic growth expectations

If there was one area where the authorities appeared rather optimistic, it was with regard to the growth boost from planned spending. They estimate that potential growth has already risen from 1.5% some years ago to around 2.0% now. The boost comes from improvements in the macro policy framework, which have lowered the real equilibrium interest rate in the economy by reducing risks in the economy and its sensitivity to external shocks, thereby boosting the total factor productivity. The economic growth of 2% with stable inflation was a case in point. Hopes are that the additional government spending in infrastructure, health and education will boost potential growth to 3% or more in 2021, by strengthening human capital and health standards. Under current conditions, we expect Russia to grow 1.3% y/y in 2019 and 1.6% y/y in 2020, while potential growth hovers around 2%, hence we are a bit more pessimistic than potential.

Government is too optimistic about economic growth in our view



Source: Macrobond Financial, Danske Bank

Many observers thought that the government's medium-term growth expectations were on the optimistic side. First, the government's reform package was not seen to be broad based enough, as it precluded the opening up of the economy; for example, with regard to procurement and reducing the role of the state. Second, the return to additional public investments is likely to take time to materialise. In the short run, infrastructure is set to increase demand but boost supply over time. Pension reform is also set to affect growth potential in the long term, along with the impact of better education and health standards on human capital. The target of reducing poverty by 50% by increasing minimum wages and pensions and refocusing transfers is seen as feasible.

What could happen if economic growth does not match the President's expectations? One fear is that the government could adopt a 'let's do whatever it takes' approach. A warning example was the development bank (VEB) expansion after the oil windfall in 2006-12. Most of the assets of the bank have now turned sour and the government has had to transfer funds given the bank was a big Eurobond issuer.

Russia could also benefit tremendously from trade liberalisation. Although the country became a part of WTO in 2102, the economy was still a fairly closed economy. Yes, Russia had free trade agreements with Vietnam and was negotiating with Egypt and Israel in addition to the union with Kazakhstan and Uzbekistan but the trade agreements covered only 1.5% of global GDP. FDI could come in with fiscal rule and could support Russian exports but sanction risks would most likely be an important detrimental factor.

Risk of sanctions and possible impact on Russian economy

One of the key risks for the Russian economy is the prospects for tougher US sanctions. On 2 August 2018, a group of six US Senators from both the US Democratic and the US Republican parties introduced draft legislation called the 'Defending American Security from Kremlin Aggression Act of 2018', which was named a 'sanctions bill from hell' by US Senator Lindsey Graham. The bill introduces sanctions against new production of crude oil in Russia and prohibits transactions with Russia's new sovereign debt, imposing additional sanctions (e.g. freezing property in the US) on selected Russian banks. We estimate that the probability the bill becomes law before the 2020 US presidential election still exceeds 50%.

The authorities viewed the Russian economy as more resilient to new sanctions. Russian companies have brought down their exposure to international debt markets following the crisis. As a result, the current account surplus is set to more than cover upcoming debt redemptions. Hence, even if the Russian corporate sector is shut off completely from international capital markets, the Russian authorities would have sufficient funds to keep the sector operating. In a harsh scenario, where the new US sanctions are enforced in full, the central bank would most likely set up FX and RUB liquidity facilities in response to pressures in the financial and corporate sectors. Furthermore, the central bank would be likely to hike policy rates (to avoid the second-round inflation effects of a possibly weaker RUB).

Among the sanctions being considered are sanctions on Russian government debt (OFZ). However, given discussion has been ongoing for some time now, foreign investors have reduced their positions already. Foreign ownership is now only 24% of total outstanding bonds, down from 36% before the discussions started. In addition, of the 24% foreign holdings, it is estimated as much as 50% is held by Russians living abroad, who may be less sensitive to changes in the sanctions regime.

Another possible serious leg of sanctions could target selected Russian banks. However, the latest draft from the US congress was generally perceived to be softer, leaving out mentioning specific banks by name and leaving the decision on the banks to President Donald Trump. The impact on the banks of sanctions could be significant, as the banks could experience foreign currency deposit run. A key question was whether the sanctions would apply only on a forward-looking basis or relate also to past actions. Views were mixed on this issue, as the draft sanctions text was seen as ambiguous. Overall, the Russian banking system's strength has improved following a substantial restructuring process, with all banks undertaking fraudulent practices restructured, or in the process of restructuring.

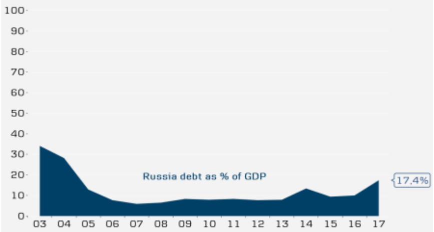
A third leg of sanctions is penalising third countries involved with Russian oil gas companies. This could hit, in particular, countries such as Germany and other European countries involved in the Nord Stream 2 project. Some observers saw the US motive as more commercial than political: in recent years, the US increased the supply of gas to the European market with the decline in the cost of US gas and the Nord Stream pipeline could threaten this business. Another US consideration is the possible sizeable impact on the Ukrainian budget, which currently relies on revenues charged on Russian gas supplies going to European markets via Ukraine. However, the macroeconomic impact in Russia of this type of sanction would be negligible.

Political outlook: planning for succession of the president

A key question facing Russia and investors is the possible succession plans after President Putin's term ends in 2024. Most analysts expected him to stand down as President but believed that he would remain active behind the scenes. Recently, he has been more withdrawn from public life and policymaking. In terms of his successor, there was an expectation that he would pick his own preferred candidate. Other options were technocrats in the system. It is likely Putin would prefer a safe candidate, which would not trigger political instability.

Despite a decline in the government's approval ratings lately, most did not expect a public outcry for a radical political change anytime soon. Despite the decline, observers pointed out that Russians were economically freer now (they can travel outside Russia) and enjoying higher standards of living. Ordinary Russians were probably also wary about too much democratic freedom given that the risk of political infighting between regions could destabilise the Russian society. Public support for the opposition candidate Alexei Navalny has not managed to spark a widespread strong movement.

Russia has very low financing needs over next few years

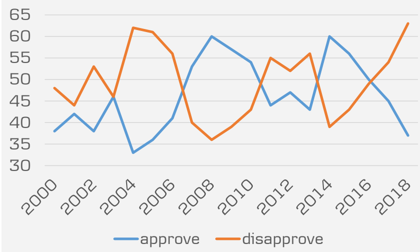


Source: Macrobond Financial, Danske Bank

Foreign ownership of Russian local currency bonds have been reduced significantly

Source: Macrobond Financial, Danske Bank

Government's approval rating has declined recently



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None.

Date of first publication

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