Russia in 2016: Good Times Bad Times?

The start of 2016 showed the economy adapts to weaker oil prices this year easier than it was expected

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Both market performance and economic data witnessed in March and April prove that the second adjustment of the Russian economy to weaker oil turns to be softer than the first one saw in 2014 - 2015. This could bring lower growth contraction at weak oil prices than suggested initially, limited chances of FX panic, a more favorable mid-term inflation outlook and, hence, require somewhat less tight monetary policy to ensure overall stability and meet inflation goals. However, the Russian budget has to be adjusted more to a new period of weaker oil prices. With all of that, we keep our scenario approach, showing in Figure 1 how Russian macro could vary this year at different oil prices.

The rouble approaches our RUB65/$ target

In April, the rouble has strengthened by 30% since its low of RUB85/$ on 21 January 2016, hitting our RUB65.2/$ mid-term target. We keep RUB65.2/$ as our base-case forecast for 2016. What's more important, we now see limited chances that the longevity of low oil prices could trigger higher demand for foreign assets and a spike in capital flight. We therefore now assume a stronger rouble at low oil prices (RUB69.5/$ at $40/bl oil; RUB77.3/$ at $30/bl oil) and move our 'panic' scenarios to a footnote (see Figure 1). A stronger exchange rate implies lower inflation in low oil price scenarios, but complicates the budget story (although the rouble has less of an effect on budget revenue at low oil prices).

Rouble benefits from subdued capital flight

The current account surplus fell to $12bn in 1Q16, from $30bn in 1Q15, mostly owing to a weaker trade surplus: exports fell by 34% YoY, which was only partially offset by lower trade imports and better non-tradeable balances. However, the financial account deficit fell to just $9bn (1Q15: $40bn) on the back of smaller external debt redemptions ($9bn vs $32bn) and subdued demand for foreign assets by non-financial entities ($4bn vs $9bn). As a result, the Central Bank of Russia (CBR) increased reserves by $3bn in 1Q16.. The stronger rouble in 1Q16, despite a smaller current account surplus and some reserve accumulation by the CBR, supports our view that the stronger rouble we expect this year will be mainly the result of lower capital flows ($45bn), given smaller debt redemptions, limited domestic demand for foreign assets and relatively good resilience to Fed policy tightening, given that Russian assets not over-owned by foreigners.

Core rouble risks include FX 'panic' (negative); a change in the sanctions story and privatisation (positive).

On the weaker side, risks to the rouble include FX panic and higher demand for foreign assets due to the longevity of low oil prices. However, potential upside could come from a possible improvement in the sanctions story. In our scenarios, we assume that sanctions remain in place as they are. However, the potential easing of EU sanctions in the next 12 months and/or the re-opening of external borrowing for Russian non-sanctioned entities (such as a successful

Figure 1: Oil price scenarios for Russia in 2016E

Year	2015				2016E				
Brent oil, $/bl	54	80	70	60	50	45 Base ase	40	30	20
Real GDP growth	-3.7%	3.0%	2.1%	1.2%	0.4%	-0.6%	-1.1%	-2.1%	-3.2%
RUB/$, annual avg	61.3	52.9	55.2	58.1	62.4	65.2	69.5*	77.3*	87.6*
Rouble, % change	-37%	16%	11%	5.4%	-2%	-6%	-12%	-21%	-30%
Inflation, annual avg	15.6%	6.4%	6.5%	6.7%	7.3%	8.0%	8.8%	9.4%	10.8%
Current account, $bn	66	103	82	68	52	44	39	33	27
% of GDP	5.1%	5.9%	5.1%	4.6%	3.8%	3.5%	3.3%	3.3%	3.1%
External debt, $bn	515	504	498	492	484	479	473	463	452
% of GDP	41%	29%	31%	33%	36%	38%	40%	45%	53%
FX reserves, $bn	368	423	404	391	380	373	368	361	353
Months of imports cover	23	20	21	21	23	24	25	29	35
Budget balance, % of GDP**	-2.4%	1.3%	0.3%	-0.8%	-2.1%	-2.8%	-3.4%	-5.3%	-8.2%
GDP, RUBbn	79.5	92.0	89.4	86.8	84.5	83.1	82.1	78.9	75.2
GDP, $bn	1,303	1,738	1,620	1,494	1,354	1,274	1,181	1,021	859

** Could be **RUB76.2/$** at **$40/bl** oil, **RUB92.7/$** at **$30/bl** oil, **RUB107.8/$** at **$20/bl** oil, in the event of higher capital flight than in other scenarios.*
*** Assuming only spending cuts of RUB0.5trn to RUB15.6trn.*
Source: Rosstat, CBR, MinFin, Bloomberg, Renaissance Capital estimates

placement of a sovereign eurobond) could potentially lead to some additional capital inflows. Additional benefits could come from recent Russian privatisation efforts. Having said all of that, we think the rouble is unlikely to beat significantly our scenario estimates for stronger oil prices, as the CBR is likely to consider not only higher oil prices but also smaller net capital outflows as an opportunity to restore reserves.

We see a smaller growth contraction at weak oil prices

We maintain our base-case -0.6% growth forecast at $45/bl oil. However, with 1Q16 macro data now available, we believe we overestimated the potential growth contraction at weak oil prices, and revise our growth estimates upwards to -1.1% at $40/bl oil (vs -1.5% previously) and -2.1% at $30/bl oil (vs -3.7% previously). In our base case, we believe growth could turn positive in quarterly terms as early as in 2H16. We estimate growth could exceed 1.5% in 2017 at a flat oil price, or be even stronger at a higher oil price. Our estimates are broadly in line with the recent CBR statements, in particular, highlighting that Russian economy became more resilient to oil prices changes. The CBR assumes Russia could exit the recession, i.e. its quarterly GDP growth could turn positive, as soon as in 2H16 (or no later than early 2017). We estimate growth could exceed 1.5% in 2017 at a flat oil price, or be even stronger at a higher oil price.

Import substitution helps to some extent

The CBR notes that the gains of a weaker currency; the ongoing import substitution in certain industries and the rise in non-commodity exports provide some support to industrial production and overall economic performance. We already see that fundamentals did become much better in this regard. Manufacturing labour costs in Russia is likely to be as cheap or cheaper than in China, in US Dollar terms. Per capita GDP in Russia could be lower than in China in 2016 (on IMF estimates) or more or less on par (on our estimates) – and this may be the first time this has happened in a century (Russia may well have been lower in the Civil War) or two. We do see encouraging import substitution – but in a limited number of industries, including food, chemical, petrochemical industries and textiles. More requires domestic demand recovery, more affordable credits and just time. However, with competitive advantages being back in place, we think import substitution could be gradually moving forward as domestic macro environment improves.

Inflation also beats initial expectations

Given the most recent inflation data, we revise down our base-case year-end inflation forecast slightly, to 7.2% (from 7.7% previously). We lower by c. 1% our year-average inflation estimates in our stronger oil price scenarios, and more significantly in our weaker oil price scenarios, given that we assume as our base case no FX 'panic' at weak oil prices. Overall, we believe our more benign inflation outlook stems from both weak consumer demand and a normalisation of the pass-through effect from rouble depreciation we saw at the start of the year. We acknowledge that some decline in the pass-through effect could be attributed to the rouble rally witnessed at the start of the year, with some domestic prices not taking account of a rouble weaker than RUB75-80/$, as it has been trading at stronger than RUB70/$ since the middle of March.

We are looking for a cautious monetary policy easing

In our view, it is too early to say whether inflation is likely to decline below 5% in 2017 (we maintain our 5.4% year-end forecast at $50/bl oil) and reach the CBR's 4% inflation target thereafter. At a $45/bl year-average oil price, we would expect a 200-bpt policy easing by year-end, from 11% currently to 9%. At $30/bl oil in 2016 we see no change in rates during the year; at $40/bl oil we see only a 100-bpt rate cut. In 2017, at $50/bl oil, we assume the key rate could be cut by another 200-bpt, to 7% by year-end, but we think this is a cautiously optimistic estimate. However, we would not expect a more pronounced or faster rates cuts as the CBR is likely to remain cautious.

Do authorities start to put less emphasis on the oil price?..

Interestingly, in the statement after 29 April 2016 interest rates decision the CBR paid less attention to external environment than previously, mentioning 'oil uncertainty' as a potential inflation risk only at the end of the statement. We think this is broadly in line with the recent incentive of state officials to pay less attention to oil trends (and have less hopes for positive spillovers of its possible recovery) but focus more on bringing forward domestic efforts. At least, we mentioned this mood that at the recent MOEX Forum in Moscow.

... and could it mean that we should hope for reforms?

Well – the answer is largely … as always, fairly unlikely. We do not see evidence of deep structural reform in Russia. Overall, the last years proved that Russian authorities are quite good and efficient with providing proper anti-crisis management, but lack performance with mid-term reforms agenda. However, some positive development in certain areas could bring some fruits. The ongoing EODB reforms are likely as Russia sees the need to develop a SME sector. The central bank is being very serious in targeting a reduction in inflation towards 4%. Plans to force state-owned companies to increase dividends are aimed at improving government finances, but might also encourage more efficiency in these companies (paying dividends is now a patriotic duty). The government has been prepared to accept constructive bankruptcies, such as Transaero (although it was taken over by Aeroflot). Privatisation of existing equity stakes in companies and banks such as VTB is also promised. Russian officials have also made significant progress in developing the domestic financial market, via improved regulation and the merging of MICEX and RTS into MOEX.

On a worrying side, the budget policy requires further adjustment

The Goevrnemnt expanded significantly state spending during period of high oil prices. Thus, social spending was up from 9% of GDP in 2005-2008 to 14% of GDP in 2015; security and defense – up from 5% of GDP in 2005-2008 to 7% of GDP in 2015. The general strategy implies keep spending generally flat in nominal terms (i.e. cutting in real terms), rely more on sovereign funds in 2016 – 2017 ($50bn in the Reserve fund & $57bn in the National wealth fund left) and higher domestic borrowings from 2018 and onwards, when rates are supposed to be much lower; affords to launch some privatization. However, budget consolidation is not an easy task, and we could some negative headlines before the Government comes up with a final solution.