Flash Comment #110

March 02, 2017

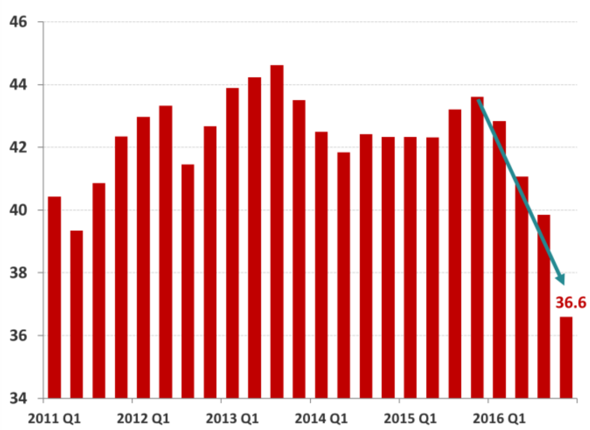
Vigorous improvement in Russia

TAC ECONOMICS' Economic and Financial Risk highlights a solid improvement for Russia since the end of 2015, thanks to the better exchange rate competitiveness and the positive momentum of activity. Indeed, the recent positive output figures confirm the exit from recession. Therefore, and in spite of persistent geopolitical issues and a reliance on oil and gas, Russia outlook is more optimistic for 2017 and 2018. The gradual increase in oil prices (towards 60$/b in 2017), the accommodative monetary policy allowed by a declining inflation rate, and the modest strengthening of the Ruble clearly improve the overall economic and financial risk. The sovereign risk remains favourable, and Russian corporates should be less vulnerable to payment/funding problems.

Economic performances have robustly improved

TAC ECONOMICS' Economic & Financial Risk rating for Russia has improved markedly since end-2015 (43.6-C) to enter favourably in the *low risk* category in 2016Q4 (36.6-B), a record low for Russia.

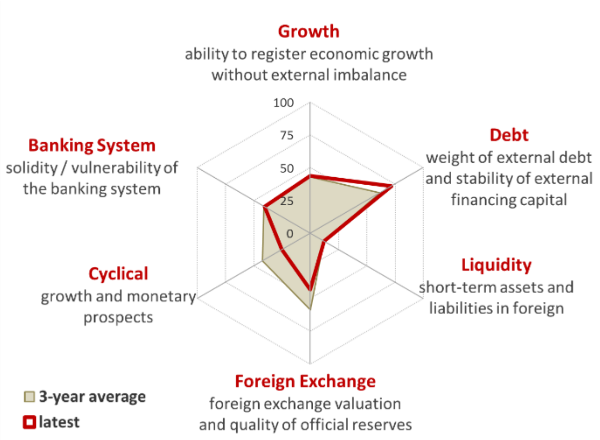
Russia – Economic & Financial Risk Rating
from 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

Such a sharp improvement is rarely observed on our ratings. And as highlighted by our polygon of risks, it is mostly explained by a lower risk on two Fundamental Balances, namely the Foreign Exchange and the Cyclical Balances.

Russia – Scores on Fundamental Balances
from 0 (lowest risk) to 100 (highest risk)

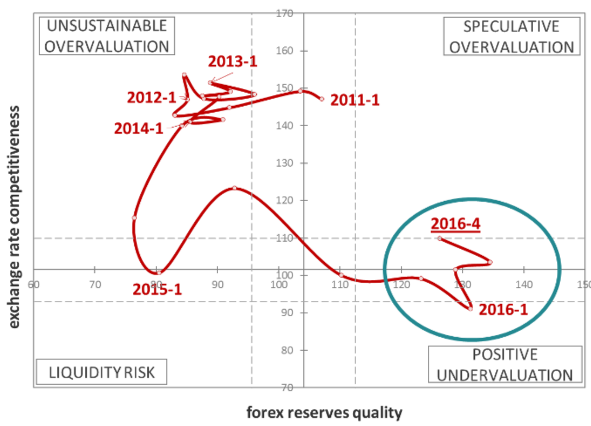


Source: TAC ECONOMICS

A Ruble closer to a "neutral valuation"

The substantial depreciation of Ruble (-60% against USD between mid-2014 and early-2016) and the simultaneous fall of oil prices (from 115$/bbl to 29$/bbl over the same period) has allowed a substantial and positive adjustment of the *exchange rate competitiveness* on our Foreign Exchange Balance. Indeed, the Ruble was overvalued by around 50% in 2014, the Exchange Rate Balance indicating an *unsustainable overvaluation.* But the massive depreciation of 2015 has clearly contributed to recover a competitive advantage in 2016, with an undervalued currency around -10% in 2016Q1, associated with an improvement of forex reserves dynamics and volatility.

Russia – Foreign Exchange Balance



Source: TAC ECONOMICS

This large forex adjustment led to a recovery in external balances. The current account surplus therefore increased to USD 69bn (i.e. 5.2% of GDP) in 2015, against USD 58bn (i.e. 2.8% of GDP) in 2014. However, since 2016Q1, the re-appreciation of the Ruble (by around 30% to USD/RUB 58.4 in Feb. 24, 2017) has slightly dampened this improvement to 2.5% of GDP in 2016. Indeed, while exports have continued to rebound (+8.3% y/y in Dec. 2016), imports have also picked-up over the same period (+10.6%) due to the simultaneous recovery of domestic demand. However, we are still far from the overvaluation observed in 2014, and the Exchange Rate Balance still shows that the Ruble is now close to a “neutral valuation” (ceteris paribus).

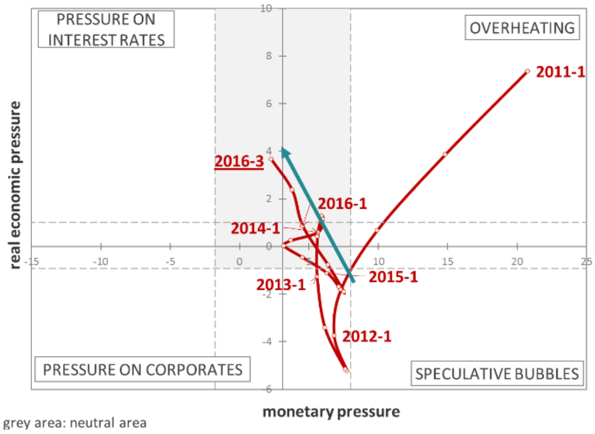
Regarding the perspectives on the Ruble for 2017, all statistical analyses clearly confirm that the Ruble is clearly influenced by oil (and gas) prices. Our models on energy prices point towards an irregular stabilization of Brent prices around 60$/b in 2017, implying an average increase of 25% over 2016. Therefore, the Ruble should continue to appreciate slightly in 2017, reaching USD/RUB 55 at the end of the year.

Better momentum of activity

Even though economic growth will remain slightly negative for the full year-2016 (-0.2% y/y), the exit of recession has taken place, according to the positive estimates of GDP growth for 2016Q4. Past currency adjustments associated to an accommodative monetary policy have allowed a relatively rapid exit from recession (e.g. as compared to Brazil’s slow recovery). As revealed by our Cyclical Balance, the positive dynamic of *real economic pressure* between 2015Q2 and 2016Q3 (traditionally in advance by 4-6 quarters) suggests a continuous positive momentum of activity ahead i.e. at least until 2017Q3-2018Q1. The gradual recovery of industrial production (+2.3% in January 2017) helped by a better *exchange rate competitiveness* and associated to better confidence indicators (visible by the large rebound of the Manufacturing Purchasing Manager Index to 54.7 in January) confirm the expected GDP growth recovery in Russia toward +1.0/+1.5% in 2017/2018.

Additionally, the gradual slowdown of inflation to +5.0% y/y in January 2017 (against +9.8% one year before) supported by the continuous Ruble appreciation over the last year (around 30% against USD), a conservative fiscal policy and a positive harvest, should continue to sustain real wages and domestic demand. In this context of declining inflationary pressures and a slight expected appreciation of Ruble related to positive stabilization of oil prices, the Central Bank (CBR) will continue to ease its monetary policy, with a likely 100bps cut in 2017 (key rate at 10% currently). However, it is worth to note that the CBR should be more cautious in the first part of the year, in relation with the introduction in February 2017 of the program of sales/purchases by the Ministry of Finance on forex markets to make its fiscal policy more sustainable. These purchases, when oil prices exceed 40$/bbl (and sales conversely), could assuredly have potential short term destabilizing effect/downward pressures on the Ruble, leading the CBR to be more prudent in the coming months to reduce its key interest rate.

Russia – Cyclical Balance



Source: TAC ECONOMICS

A deterioration of the Debt Balance

Despites all these improvements, the Debt Balance has deteriorated due to a visible degradation of the *financing stability* and massive capital outflows following the financial sanctions from EU & US, and the collapse of oil prices from mid-2014 to early-2016. However, net capital outflows have progressively reduced to around USD 16bn in the first eleven months of 2016 (against USD 54bn in 2015), therefore the *financial stability* should recover.

Others Fundamentals Balances have remained globally stable, in a very comfortable position for Liquidity, and in intermediate positions for Growth and Banking System Balances. The *low risk* position on the Liquidity Balance is easily explained by a very large *forex liquidity*: foreign currency reserves held by the Central Bank reach USD 328bn as of January 2017 covering 20 months of imports. This is coupled with limited use of short-term external financing. The country is also positioned in a relatively comfortable area of *domestic credit risk* on the Banking System Balance due to a limited use of domestic leverage and a weak international refinancing of Russian banks. Similarly, the Growth Balance remains in an intermediate position with constant large current surplus thanks to oil/gas exports, but associated to an insufficient *economic growth*.

A better risk than in 2015/2016

Overall, the strong improvement of Economic & Financial Risk rating and the absence of Signal offer more optimistic perspectives for Russia in the coming quarters, in relation with a more favourable growth ahead (private consumption and external trade) and a more neutral valuation of Ruble. However, the country remains dependent on oil prices, geopolitical risks and financial market/volatility. Moreover, growth potential in Russia will remain constrained by insufficient investment level, challenging demography and weak productivity of labour market.