Country Focus: Russia

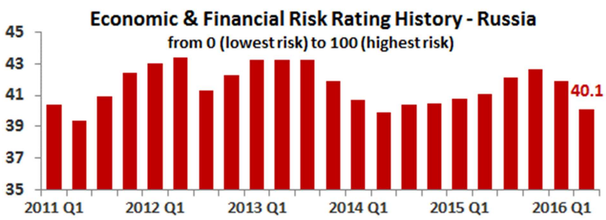
October 2016

Country Focus: Russia’s exchange rate adjustment drives away some financial and economic headwinds

In a context of oil price stabilization around 50 $/bl, the past exchange rate depreciation bringing the currency valuation at neutral levels combined with growing signs of economic activity recovery reduce the economic and financial risks in Russia. Current disinflation enabled by favourable “pass-through effects” should also support further monetary easing and reduce corporate vulnerabilities to potential funding and payment problems. Over the longer term however, persistent structural constrains (weak investment, low productivity…) and lasting geopolitical tensions and sanctions cap Russia’s potential growth.

Slightly better economic and financial outlook

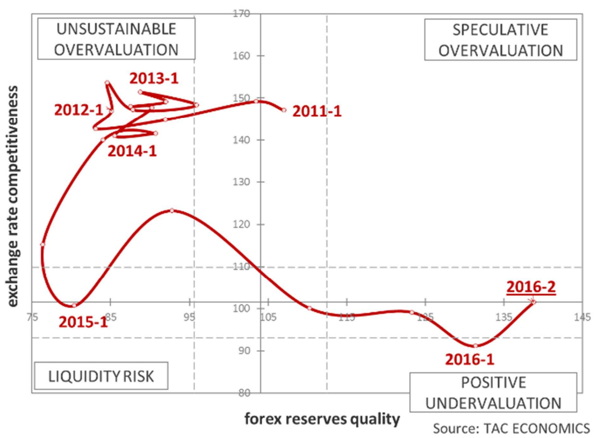
Our Economic & Financial Risk Ratings for Russia have improved, moving back to moderate level (40.1-C), after a continuous deterioration from 2014Q2 to 2015Q4, clearly suggesting a better outlook. Moreover, ratings over the different time-horizons show both parallel improvements and an “inverted” shape (higher risks for the less-than-one year, with a rating at 42.0 and lower risk for the longer 3-to-5-year horizon at 38.5).



The improvement in risk ratings can be mostly attributed by changes in the Foreign Exchange and Cyclical Balances, reflecting positive currency and cyclical adjustments.

Exchange rate correction to neutral level

The exchange rate flexibility has been a major policy tool for Russian authorities enabling the gradual recovery of external sector. While the Russian currency was largely overvalued on our Foreign Exchange Balance (+40% until mid-2014 for our index of *exchange rate competitiveness*, vertical axis on the Balance), the substantial depreciation (-55% against USD since July 2014) mirroring the collapse in oil prices (from a peak of 115 $/bl in June 2014 to a low point of 30 $/bl in January 2016) has fully erased the Rubble (RUB) overvaluation. Coupled with a sharp adjustment in domestic demand weighing down on imports, this has enabled the current account surplus to reach 5.2% of GDP in 2015, after 2.8% in 2014; notwithstanding the progressive increase in imports as the recession fades away, the current account surplus is estimated at USD 38.6 bn in 2016, i.e. around 3.0% of GDP. By allowing the RUB to depreciate, the Russian Central Bank used only a limited amount of reserves, while stricter controls on capital outflows have also supported official reserves: they have increased by USD 22bn since May 2015 to USD 331bn in August 2016, assuring a large cover of 22 months of imports. Overall, our indicator of *forex reserves quality* has improved substantially, pushing Russia’s position to the lowers risk quadrant of the Balance (*positive undervaluation*). The currency should continue to slightly appreciate toward USDRUB 60 in average in first half of 2017 (close to its current level, USDRUB 62 on Oct. 11, 2016).



Better momentum of activity ahead

The currency flexibility has also played a major role as fiscal shock-absorber allowing the country to keep healthy and sustainable budget performances: the fiscal deficit has not overpassed -4.0% of GDP and public debt remained contained at 17% of GDP in 2015. Fiscal flexibility, better oil prices and a competitive currency forcefully acting as an incentive for import substitution and export development are therefore combining to allow Russia exiting progressively the economic contraction noted since the end of 2014. Considering the current disinflationary trend (+6.4% for consumer prices in September 2016 against 15.7% one year earlier), our policy-reaction function indicates the possibility of substantial interest rate cuts in 2017, providing another support to growth.

Russia’s GDP growth shrank (only) by -0.6% y/y in 2016Q2 thanks to an expansion of agriculture, mining and manufacture while construction, wholesale and retail continued to contract. On our Cyclical Balance, the leading index of domestic momentum (*real economic pressure*) reached a trough in 2015Q2. Since then, the significant reversal (with a usual lead-time of 4-6 quarters) suggests a better economic growth ahead. Russia will exit from recession at the end of this year and would register a positive though modest GDP growth in 2017 (1% to 2%).