Russia Watch

Group Economics
Emerging Markets Research

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Central bank cuts rate further

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- **On June 16 the Central Bank of Russia has lowered its key rate to 9% ...**
- **… while flagging inflationary risks in the medium-term**
- **Headline inflation is almost on target (4%)**
- **Rate cuts and higher oil prices are good news for the economy**
- **… but longer-term prospects are subdued due to structural constraints**
- **We change our USD/RUB forecasts for end 2017-2018 to 52 and 50**

Russia has finally won the battle against inflation…

After a long period of high inflation, headline inflation has finally returned to around the central bank's target (4% at year-end). Inflation slowed to 4.1% yoy in April and May. Core inflation dropped to 3.8% yoy in May, more than expected. Food prices are an important driver of lower headline inflation. Food accounts for more than a third of the inflation basket. Food prices increased sharply in 2014 and 2015 after the US and EU imposed sanctions following Russia's annexation of Crimea. Russia retaliated with counter-sanctions and imposed import bans on all sorts of food and agricultural products. Food price inflation peaked at nearly 25% in mid-2015. Since then, Russia has increased domestic production of agricultural products and redirected its trade of food products to focus on China, bringing food prices down. A good harvest in 2016 also pulled down prices. However, food price inflation started to rise again somewhat in April and May. Overall, food price inflation currently stands at 4%. In addition, the ruble appreciation that has been seen since early 2016 has suppressed imported inflation. The ruble has appreciated by more than 25% since the start of 2016, from USD/RUB 78 in early 2016 to USD/RUB 57 today.

… but it will be difficult to keep the inflation rate on target

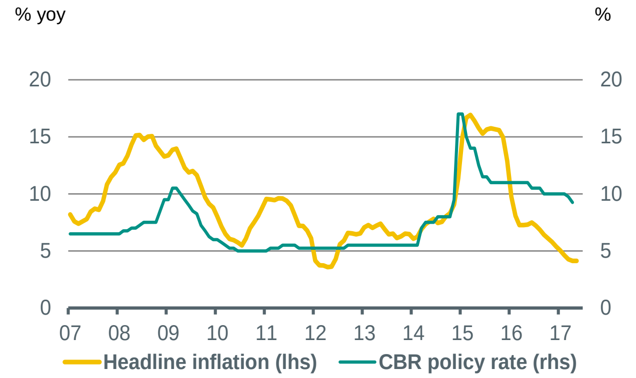
We believe that inflation has now bottomed out and will move slightly higher over the coming months (4.5% by year-end). The central bank predicts a inflation of 4.2% in June, slightly up from May. Both April and May saw faster gains in food prices than earlier in the year. It is crucial to anchor inflation expectations to the target to avoid demands for higher wages. This is a difficult process and inflation expectations are very sensitive to certain consumer categories (e.g. food). What is more, we expect the ruble to appreciate slightly, but not at the same pace as in 2016. That is why the contribution of lower imported inflation will decrease. Furthermore, the ongoing economic upturn will increasingly result in greater pressure on inflation from the demand side.

Central bank resumes easing cycle

End-2015, the CBR increased its key policy rate substantially because of a sharp increase of inflation. Since then the CBR has lowered rates cautiously. At several occasions it has kept interest rate constant, while inflation was decreasing. Against the backdrop of an improving inflation picture over the past few months, the Central Bank of Russia (CBR) reduced its key policy rate in March and April by a cumulative 75 bp and by another 25 bp in its meeting on 16 June. The April and March rate cuts were in sharp contrast with the hawkish message the CBR issued earlier. As a result, these rate cuts were deeper than the market expected. This shift in monetary policy is a consequence of the lower-than-expected inflation rate and a decrease in inflation expectations. The relative strength of the ruble has given CBR the freedom to cut the official rate more aggressively. However, in the accompanying statement of the June rate cut decision, the CBR signalled that it expected inflation to rise again over the medium-term.

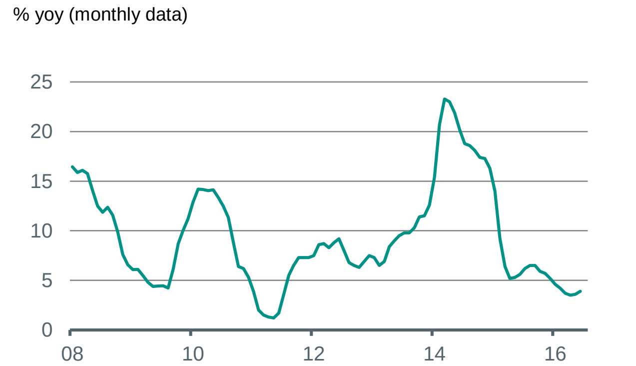
We expect that the CBR will weigh further monetary easing very carefully. However, with inflation currently at target and our expectation of a stronger ruble, there is some scope for further interest rate cuts. In March, the Central Bank Governor announced that additional easing will come in small increments, which makes another rate cut of 50 bp unlikely. Given our concerns about inflationary pressures, we expect only two further 25 pb rate cuts. That would bring the key rate to 8.50% by the end of this year. Our forecast is slightly less dovish than market expectations (median forecast of 8.25%, but with sharp variations in expectations).

Inflation and key rates are coming down



Source: Thomson Reuters Datastream

Food price inflation has dropped sharply



Source: Thomson Reuters Datastream

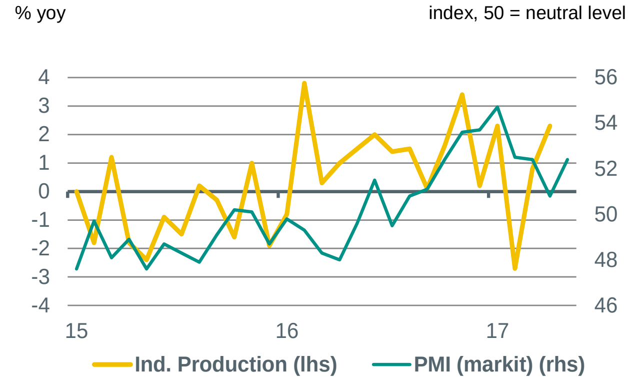
Rate cuts and higher oil prices are good news for the economy

After a period of negative growth in 2015 and 2016, economic growth turned positive in Q4 2016. This recovery continued into the first quarter of 2017 when real GDP increased by 0.5% yoy, slightly above market expectation. Growth in the first quarter was driven by a robust increase in investments and improving consumption (less negative). Growth was subdued, however, because of unfavourable external sector dynamics. Discounting for the higher oil prices and the ruble appreciation, exports in real terms increased by 5% in Q1 2017. Imports, driven by the strong ruble, increased by as much as 14% in real terms, resulting in a deterioration of the trade balance.

The monthly economic indicators give a mixed message, but we interpret them as indicative of a further economic recovery. The Purchasing Manager Index (PMI) has been on a downward-trending path since January (when it stood at nearly 55) and bottomed out in April (50.8). Nonetheless, the recent May figure (52.4) was above expectations. Growth of industrial production has been positive since 2016; although it dropped by almost 3% yoy in February due to some one-off effects, has strengthened since. Retail sales point to a further recovery as well. April was the first month in which retail sales has not shown a contraction in annual terms since early 2015. That said, the average growth of retail sales in 2010-2014 was 5%, so there is certainly room for further improvement.

We expect oil prices to show a further rise since US crude stockpiles have started to decline and investments have remained under pressure, which has a negative effect on supply growth. Our oil analyst uses a year-end target of $60/bbl. This will be beneficial for Russia, since crude oil, petroleum products and natural gas comprise roughly 60% of total exports. With oil prices running higher than $40/bbl, the government has the resources to stimulate the economy. The government starts from an oil price of $40/bbl for its fiscal budget. We expect public investment to increase ahead of the presidential elections in March 2018. With higher public wages and pension indexation, private consumption should also pick up. On balance, we expect annual economic growth to return to positive territory in 2017 (1%) and 2018 (1.5%).

PMI and IP give a positive signal



Source: Thomson Reuters Datastream

Growth turns positive in Q4 2016

Source: Bloomberg

Relief of sanctions presents upside risk, oil price presents downside risk

The relief of sanctions imposed by the EU and/or US present a potential upside to growth. It is difficult to assess the extent to which the sanctions have impacted the Russian economy. The substantial drop in oil prices (by more than 60% between the start of 2014 and the end of 2015) coincided with the sanctions, so it is difficult to pinpoint the isolated effect of the sanctions. The financial sector has suffered the consequences of the cut-off of financial flows from sanctioning countries. The EU has prolonged sanction against Russia two months ago until at least September 2017. This week, the US senate voted for a package of additional sanctions on Russia, in part to punish the country for alleged interference in the 2016 US Presidential elections. As a result, the potential upside for a relief of sanctions will not materialise until 2018.

Our base-case scenario for Russia foresees a recovery in oil prices (to $60/bbl at year end), but there are substantial downward risks to this scenario at this time. For a start, US shale production could recover faster than expected, sending oil prices lower. In addition, OPEC may not be able to convince financial markets that all members will live up to their pledged output cuts. Finally, global oil demand growth may not be as strong as anticipated at the beginning of this year. All things considered, there is a greater chance of oil prices ending up below $60/bbl than above $60/bbl.

Long-term growth prospects still subdued

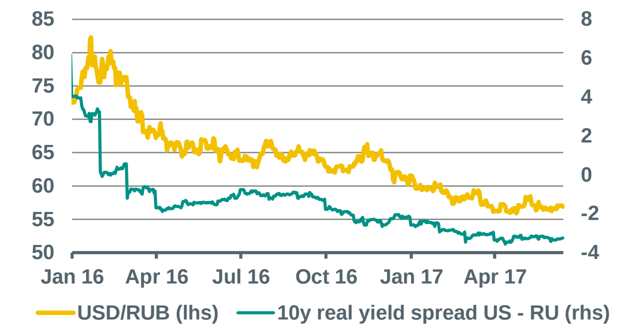
Even before the implementations of the sanctions in 2014, Russia's economy faced structural constraints that prevented the economy from achieving higher growth. According to the World Bank, long-term potential growth has declined since 2013 from more than 5% to below 3%. Most of the decline in long-term growth was due to the fall in factor productivity growth (TFP), a result of the sluggish movement of resources from unproductive sectors to productive sectors, bureaucracy, red tape and the absence of rule of law. It is unlikely, in our opinion, that a structural reform plan will bring about fundamental changes in the Russian economy, the reason being that the sitting government has too many vested interests in keeping things as they are. Furthermore, efforts to diversify the economy (away from oil) remain weak. Government investment is still focused on traditional sectors. FDI, which is associated with strong technological spill-overs, remains weak in the context of economic sanctions. All in all, we expect economic growth to recover in 2017 (to around 1%) and 2018 (to around 1.5%), but to remain well below the levels seen earlier and right after the global financial crisis.

Ruble has strengthened and will continue to do so

The ruble is a currency that thrives in an environment of constructive investor sentiment. In such an environment, investors are willing to take positions in emerging market currencies, commodity currencies or growth-sensitive currencies as they search for a better performance/yield pick-up. The US-Russia real yield spread has diminished and this has supported the ruble (see chart below). In general, lower US real yields have weighed down the US dollar across the board. Moreover, a relatively stable oil price has supported the ruble as well. Last February, the Finance Ministry introduced regular FX purchases (buying US dollars or euros for rubles if the oil price is above USD 40 per barrel). However, the volume of FX purchases was too small to have a significant impact on the ruble.

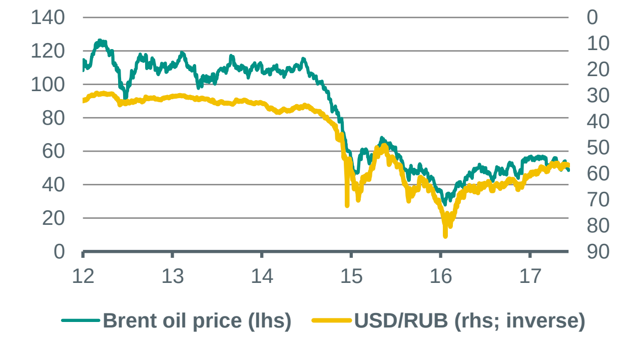
Going forward, we expect that investor sentiment will remain constructive and our oil analyst forecast oil prices to rise to USD 60 per barrel by the end of this year. This will probably result in further upward pressure on the ruble versus the US dollar, because of the attractive nominal and real yield differential. Moreover, we expect that investors will continue to reduce their speculative net US dollar longs as the US political environment has dampened optimism about US dollar strength. The failure of the US dollar to rise when the stars were aligned reminded investors that the US dollar has probably already peaked. The ruble will profit from this. Speculative positioning in the ruble is relatively light (see chart below), so this will unlikely be a force that is holding the ruble back. Although the central bank will probably lower interest rates, it is likely that the attractive carry will continue to support the ruble.

Spreads become more negative



Source: Bloomberg

Ruble has appreciated against the dollar



Source: Thomson Reuters Datastream

Still, there are some risks that could send the ruble into a downward spiral. The first is a sharp drop in oil prices, the second is a sharp wave of risk aversion and the third is a political escalation between US and Europe on the one hand and Russia on the other. But these scenarios are not part of our base scenario. All things considered, we have upgraded our ruble forecasts. We see most of the upside in the ruble in 2017 because of our view of the oil price and the US dollar. We changed our new year-end forecasts from 61 to 52 for 2017 and from 58 to 50 for 2018.

Key forecasts for the economy of Russia

	2014	2015	2016e	2017e	2018e
GDP (% yoy)	0.8	-2.8	-1.0	1.0	1.5
CPI inflation (% yoy)	7.8	15.5	7.0	5.0	4.5
Budget balance (% GDP)	-0.4	-2.4	-3.5	-3.0	-1.5
Government debt (% GDP)	9	9	10	13	14
Current account (% GDP)	2.8	5.1	2.0	3.0	2.5
Gross fixed investment (% GDP)	21.1	20.8	21.0	21.0	20.9
Gross national savings (% GDP)	24.9	27.3	25.3	26.0	25.2
USD/RUB (eop)	56.3	72.9	61	52	50
EUR/RUB (eop)	68.1	79.2	64	60	60

Economic growth, budget balance, current account balance for 2017 and 2018 are rounded figures
Source: EIU, ABN AMRO Group Economics

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