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Russia

The land of contrasts

We soften our 2019 forecasts, but still forecast 1.4% growth and a RUB67/$ exchange rate (at a $60/bl oil price) if sanctions are unchanged. Under the scenarios we examine for a potential tightening in sanctions, we think the rouble and asset prices might be hit hardest, but the macro shock could be much milder than in 2009 or 2014/2015.

Russia offers the most contrasting macro story in the EM space

On the one hand, the Russian domestic macro story appears very predictable: Russian economic policy strongly prioritises stability (low inflation, fiscal discipline, reserve accumulation) over other goals. Ironically, in order to improve growth prospects, this summer authorities ended up raising VAT and halting rate cuts (which is of course rational but at first glance appears counter-intuitive). On the other hand, contagion effects from external factors are the opposite – no one is sure where the sanctions story will go.

2019 forecasts are softer even if sanctions are unchanged

We soften our 2019 forecasts due to recent capital outflows triggered by sanctions and higher VAT. In our base-case of $60/bl oil, we expect growth to decelerate to 1.4% (previous forecast: 2%) from 1.9% in 2018E (with budget changes shaving a net 0.3 ppts from growth) and the rouble to average RUB67/$. Annual inflation could almost double to >5.5% in March-April, triggering three consecutive 25-bpts rate hikes to 8.0%. However, if the oil price remains at $80/bl and there are no new sanctions, we believe rate hikes can be avoided. In 2020, we forecast 2.4% growth recovery, supported by a revival in domestic demand as well as an increase in the retirement age, a stable currency, 4% inflation and rate cuts, even if the oil price remains unchanged at $60/bl.

What could the impact be of potential new sanctions?

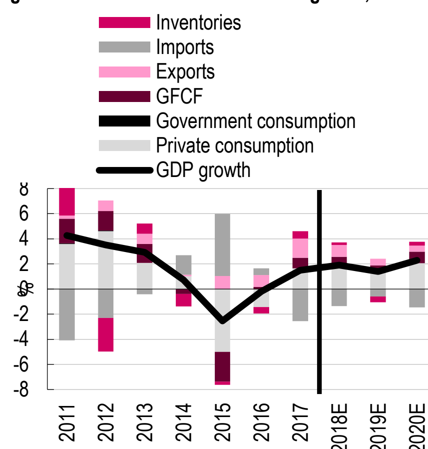
The major risk we see is the sanctioning of newly-issued state debt. We do not think this is likely but consider two risk scenarios for 2019: in a ‘soft’ scenario, we assume that non-residents reduce their exposure to previously-issued OFZs to 2Q15 lows (18% of the market), which would accordingly trigger additional outflows. A total >$40bn extra of capital outflows would weaken the year-average exchange rate by 7-10% (the short-term impact would be more significant), to RUB67-74/$ at $80-60/bl oil, but growth would remain positive. In a ‘hard’ scenario, with non-residents reducing their exposure to 10% of the OFZ market and a subsequent $70-80bn rise in capital flight, we estimate the year-average exchange rate would weaken by 14-18% to RUB82-72/$ at $80-60/bl oil and the rate would rise by 5-7% at year-end; however, the recession would not be deep (-1% growth). We estimate separately that a 10-bpts rise in Russia’s risk premium weakens the rouble by c. 1-1.5%. This simplified approach suggests that the rouble will stabilise at RUB71/$ if the Russia 2023 - UST spread widens by 40 bpts to 200 bpts.

Figure 1: Oil scenarios for Russia

Year	2018E	2019E									2020E
Brent oil, $/bl	70	100	90	80	70	65	60 Base case	50	40	30	60
Real GDP growth	1.9%	2.3%	2.0%	1.8%	1.6%	1.5%	1.4%	0.9%	0.4%	-1.4%	2.4%
RUB/$, annual avg	62.2	57.1	59.0	62.3	64.5	65.6	67.1	70.5	73.0	81.0	68.5
Inflation, annual avg	3.0%	4.6%	4.8%	4.8%	5.0%	5.1%	5.2%	5.8%	6.3%	8.1%	3.7%
Policy rate by year-end	7.5%	7.25%	7.25%	7.25%	7.5%	7.75%	8.0%	8.75%	11%	13%	7.5%
Current account, % of GDP	5.9%	7.0%	6.5%	5.9%	5.0%	4.8%	4.3%	3.5%	2.3%	2.9%	3.9%
Budget balance, % of GDP	1.8%	4.7%	4.0%	3.3%	2.5%	2.1%	1.6%	0.6%	-0.6%	-2.0%	1.0%
GDP, $bn	1,634	1,995	1,895	1,765	1,665	1,632	1,579	1,465	1,361	1,164	1,625

Source: Renaissance Capital estimates

Figure 2: Contributions to Russian GDP growth, %



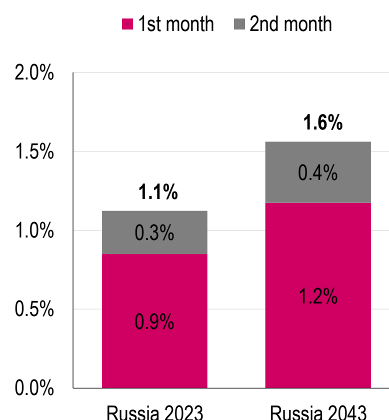
Source: Rosstat, Renaissance Capital estimates

Figure 3: Scenarios for contagion effects of potential sanctions of newly issued Russian state debt

	'Soft'		'Hard'	
Brent oil, $/bl	60	80	60	80
New outflows, $bn	43	44	71	83
RUB/$, yr-avg	74	67	82	72
GDP growth, %	0.5	0.7	-1.1	-0.6
CPI, yr-avg, %	6.4	5.4	8.6	6.3
Key rate, yr-end, %	9.5	8	15	12
Budget balance, % of GDP	2.1	3.7	2.8	4.4

Source: Renaissance Capital estimates

Figure 4: How a 10-bpts change in the Russian eurobond spread affects the rouble value



Note: The rise in the spread leaves the rouble weaker, and vice versa
Source: Renaissance Capital estimates

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Russia: The land of contrasts

This economist, after being lucky enough to see seven matches of the football World Cup in Russia, watched the final from London. During the game, UK TV commentators a few times depicted Russia as ‘a country with different faces’, as despite the geopolitical noise they acknowledged Russia’s successful hosting of the global sports event, which arguably went smoother than in Brazil and South Africa.

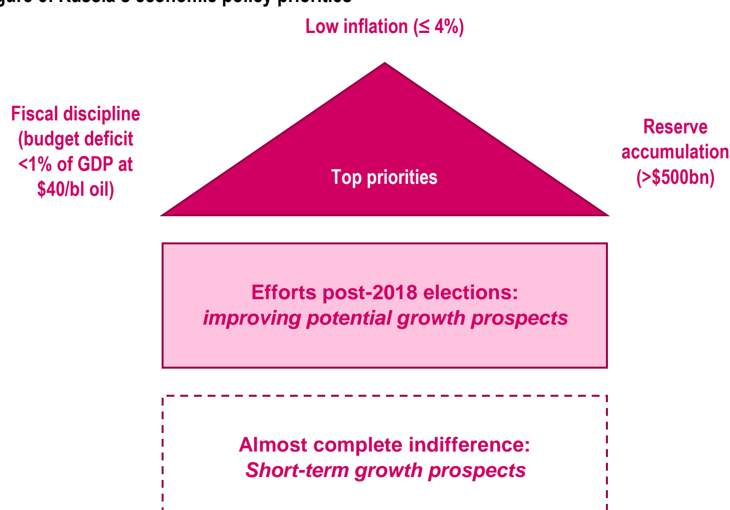
Ironically, the Russian economy today offers, in our view, the most contrasting story in the EM space. On the one hand, Russian macro appears remarkably stable and predictable domestically, but on the other hand, we doubt anyone has a good handle on what the external impact might be from potential new sanctions. As we cannot make a strong call on geopolitics, in this report we examine sanction scenarios, in addition to our traditional oil price scenarios for Russia.

Domestic ultra-stability…

A joke about economists. What does a typical economist suggest to spur growth? Reduce interest rates and higher state spending. What does a Russian economist suggest to spur growth? Stop cutting interest rates and raise taxes.

Russian economic policy strongly prioritises stability… Although this joke might be a bit outdated (conversations are all about sanctions these days), this was exactly the case in Russia before the August holiday season. In order to fulfill President Putin’s decree to improve Russia’s growth prospects, the government and the Central Bank of Russia (CBR) ultimately ended up raising VAT and announcing the end of a rate-cutting cycle. The whole idea of financing ‘smart’ government spending in infrastructure and human capital with new revenues does appear very rational, but we think the recent decisions clearly highlight the major priorities of the Russian economic authorities. As Figure 5 shows, Russian economic policy is primarily focused on ensuring stability and de-risking by: 1) keeping inflation low; 2) ensuring fiscal discipline; and 3) accumulating reserves. Potential reform efforts are focused on improving Russia’s potential growth, while ensuring these do not contradict prime stability targets.

Figure 5: Russia’s economic policy priorities



Source: Renaissance Capital

…limiting the scope for any potential surprises... The major outcome of these policies is that it appears to us quite difficult to identify any major domestic-related macro surprises. We maintain a c. 2% growth forecast for 2018 and forecast 1.4% growth in 2019 at $60/bl oil. Could growth be 3% in 2019? As our analysis below shows, we forecast only 2%-plus growth even if the oil price goes up to $100/bl. Could this be a recession? We forecast a 0.5% growth decline, but only if the oil price more than halves, falling below $40/bl. Likewise, the range for our rouble, inflation and rates forecasts appears narrow for a wide oil price range (please see the next section).

In the longer term, we think the debate will centre on 1) whether growth stays lower than 2% or could one day approach 3% (we think that it is likely to be in the middle and forecast 2.4% growth in 2020 at an unchanged oil price of $60/bl); 2) where the Russian neutral rate will be; and 3) some idiosyncratic stories around mortgages, consumer demand being more alive than dead, and spurring internet trade.

…which is what debt investors tend to like. For an emerging economy, apparent domestic stability for the foreseeable future is a strong advantage. Combined with policymakers' seemingly (almost) complete indifference to current growth prospects, we think the Russian top-down macro case is likely to be ideal for fixed income investors, but not especially fascinating for equity investors, over the next few years.

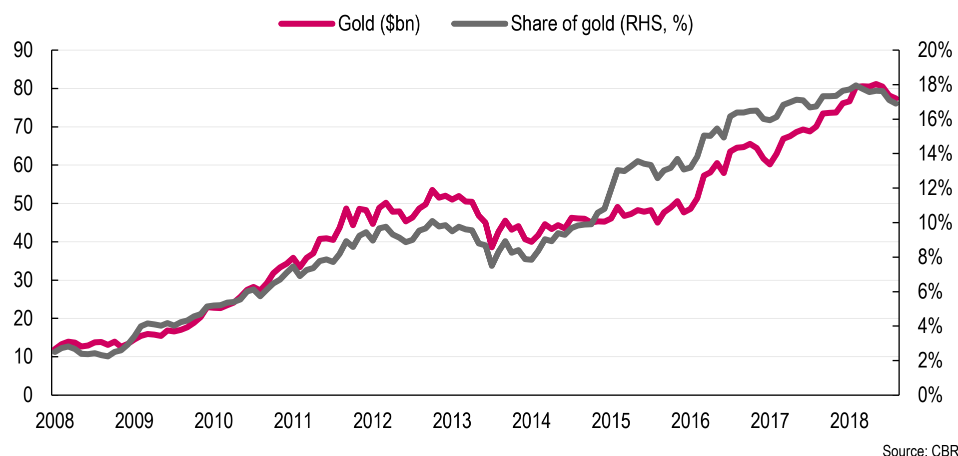
…coupled with great uncertainty around sanctions

But where could sanctions go? No one knows where the sanctions story will go. An optimistic view is that the risks that we analysed four years ago in our report, **If sanctions widen to energy exports,** were potentially much harsher for Russia. In this report, with a view to a potential bottom we are 'only' considering sanctions on newly-issued state debt. However, this is our current assumption to the period before mid-November, when the US Congress may potentially tighten the sanctions regime. A pessimistic view is that Russian isolation will intensify and things will get worse.

The potential contagion effects from sanctions for Russian macro are under better control… Russian policies are focused on stability – and the country's agenda of self-sufficiency also helps it take better control of any potential contagion risk from sanctions. Steps such as: a) developing a domestic payments system 'MIR', or reducing ownership of US treasuries to just c. $15bn of almost $500bn of reserves; b) raising exposure to gold to almost 20% of reserves (Figure 6); or c) the recent decision by the CBR limiting the local entities of global banks to depositing only a certain percentage of their capital abroad at their parent companies, could appear non-cost efficient from a regular perspective, but are quite rational, in our view, considering the prime goal is to ensure stability in a highly volatile geopolitical environment. Thus, from a survival standpoint, even tough sanctions are unlikely, in our view, to lead to some kind of economic collapse in Russia. In the scenarios we describe below, our forecasts are still some way off the 8% GDP growth contraction witnessed in 2008.

…but the rouble and prices of financial assets could a major hit. This is partly due to exchange rate flexibility – and authorities' tolerance to this flexibility. In our scenarios, the rouble in 2019 may vary from RUB57/$ to RUB82/$, as well as the geopolitical risk premium. In this regard, the prices of all Russian financial assets, in contrast with major macro forecasts, could be subject to change – complicating the story for an international investor.

Figure 6: Gold in Russian international reserves



Source: CBR

Our base case: Sanctions remain virtually unchanged

In our analysis below, we assume that sanctions remain almost where they are today. We maintain this base case mainly to avoid making a strong call on the geopolitical situation, which is subjective, however, that notwithstanding, we are also comfortable with the projections for our base case. This does not mean that we do not expect to see any new sanction decisions later this year or in 2019, but we assume that they will not be too significant a change the current sanction regime and thus will have a relatively minor impact on Russian macro and the markets. We take $60/bl as a base-case oil price for 2019, in line with our oil and gas team forecast, but consider various oil prices scenarios.

Figure 7: Oil price scenarios for Russia

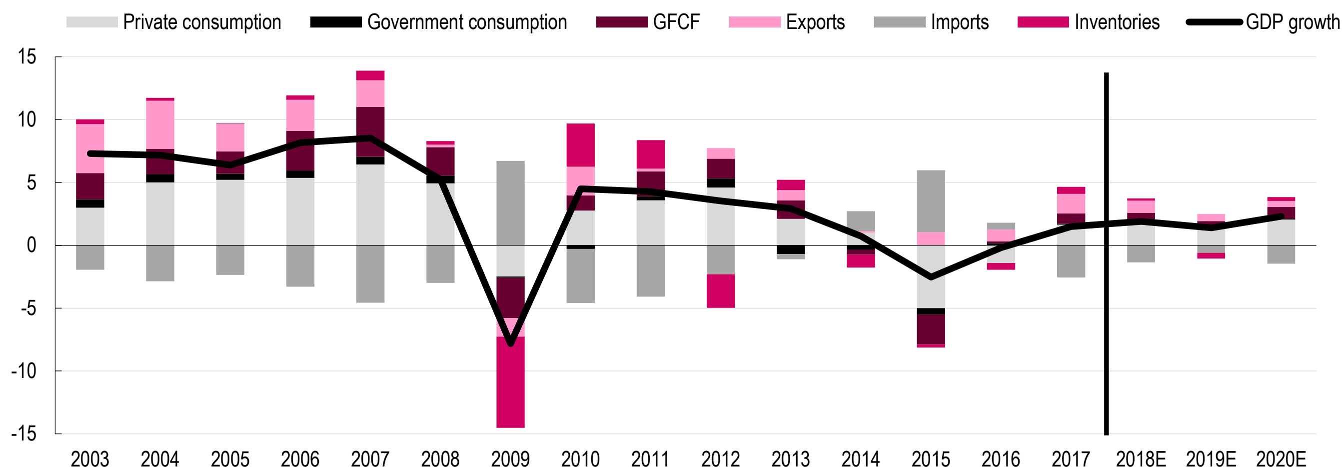
Year	2018E	2019E									2020E
Brent oil, $/bl	70	100	90	80	70	65	60 Base case	50	40	30	60
Real GDP growth	1.9%	2.3%	2.0%	1.8%	1.6%	1.5%	1.4%	0.9%	0.4%	-1.4%	2.4%
RUB/$, annual avg	62.2	57.1	59.0	62.3	64.5	65.6	67.1	70.5	73.0	81.0	68.5
Inflation, annual avg	3.0%	4.6%	4.8%	4.8%	5.0%	5.1%	5.2%	5.8%	6.3%	8.1%	3.7%
Policy rate by year-end	7.5%	7.25%	7.25%	7.25%	7.5%	7.75%	8.0%	8.75%	11%	13%	7.5%
Current account, $bn	96	139	122	104	83	79	68	52	31	33	64
% of GDP	5.9%	7.0%	6.5%	5.9%	5.0%	4.8%	4.3%	3.5%	2.3%	2.9%	3.9%
External debt, $bn	469	480	476	469	463	461	458	452	446	433	446
% of GDP	29%	24%	25%	27%	28%	28%	29%	31%	33%	37%	27%
FX reserves, $bn	484	619	601	583	564	556	546	528	496	480	588
Months of imports cover	23	24	24	25	25	26	26	27	28	33	28
Budget balance, % of GDP	1.8%	4.7%	4.0%	3.3%	2.5%	2.1%	1.6%	0.6%	-0.6%	-2.0%	1.0%
GDP, RUBtrn	101.6	113.9	111.8	109.8	107.4	107.1	106.0	103.3	99.3	94.3	111.3
GDP, $bn	1,634	1,995	1,895	1,765	1,665	1,632	1,579	1,465	1,361	1,164	1,625

Source: Renaissance Capital estimates

We forecast softer growth in 2019 followed by a recovery in 2020. We keep our 2018 Russian GDP growth forecast almost unchanged, trimming this to 1.9% (from 2.0%). In 2019, however, we expect growth to soften to 1.4% at $60/bl oil, before it recovers to 2.4% in 2020 at an unchanged oil price. We expect consumer and investment demand growth to decelerate to 2.6% and 2.7% in 2019 (vs 3.8% and 3.3%, respectively, in 2018, Figure 8), mainly due to higher inflation partly resulting from a VAT increase and tighter credit conditions than we previously assumed. If the year-average oil price remains at $70/bl, however, we forecast growth should soften marginally to 1.6%.

Why do we think growth will recover to above 2% in 2020? Apart from technically stronger demand growth, we estimate that an increase in the retirement age might increase Russian trend growth by 0.5% in the medium term. If this effect is moderate as soon as 2019, we believe that 12 months ahead of that (in 2020) it will become more apparent.

Figure 8: Contributions to Russian GDP growth, %

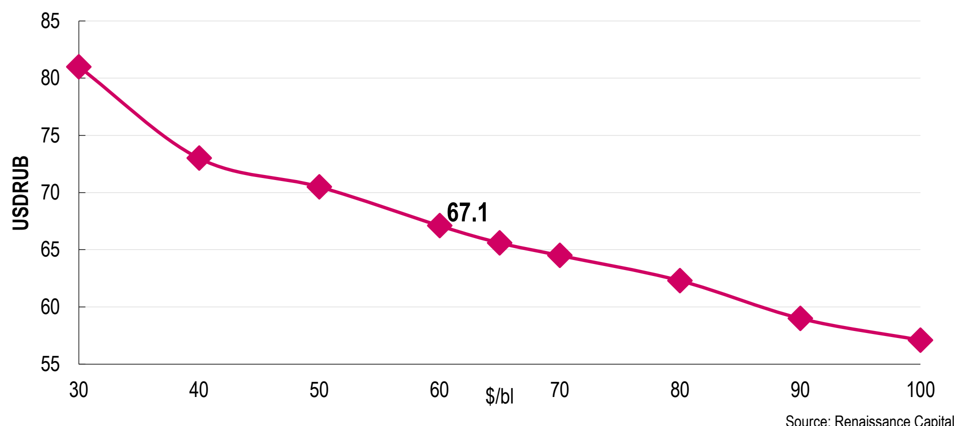


Source: Rosstat, Renaissance Capital estimates

What is the impact of a 2% raise in VAT? We estimate that the VAT increase from 18% to 20% might raise Russian inflation by 1.1 ppt and shave 0.7-0.8 ppts from GDP growth which should, however, be partly offset by increased government spending in various areas, mainly a decision to increase infrastructure spending financed by borrowing. As a result, we estimate the net impact on growth of a change in budget parameters will be limited by a 0.3 ppts only.

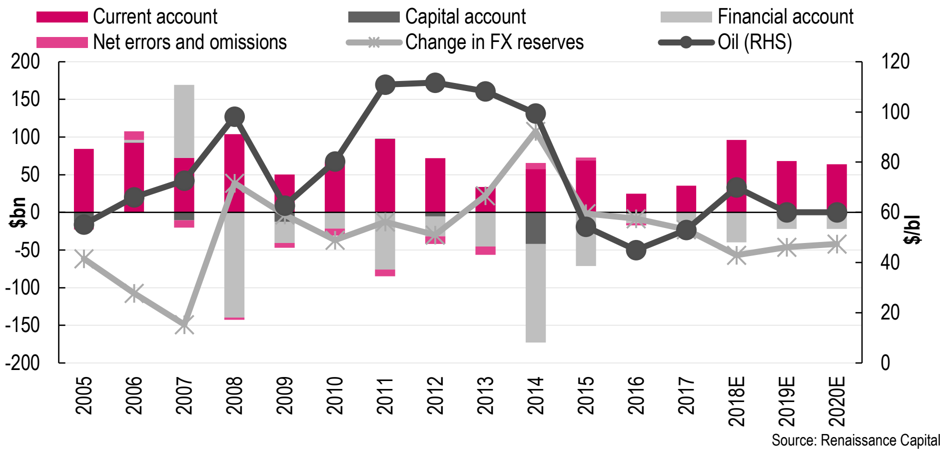
The rouble has moved to a new equilibrium zone… It appears to us that the period of RUB60/$-plus exchange rates may be over. Recent outflows, triggered by recent sanctions, have left the currency's fair value a bit weaker. At a $60/bl oil price in 2019 we forecast RUB67/$, which implies a YoY depreciation of 7%. If the year-average oil price remains unchanged at $70/bl, then the rouble could average RUB65/$ in 2019. Only if the oil price stabilises in the $80/bl-plus territory in the next 15 months, and sanctions remain unchanged (as we assume), could the currency appreciate to RUB62/$, on our forecasts. In 2020, at an unchanged oil price, we forecast a RUB68.5/$ year-average exchange rate. In all of these cases, we assume that annual net capital outflow almost halves to c. $20bn in 2019 and 2020, respectively.

Figure 9: RUB/$ estimates at different oil prices



Source: Renaissance Capital

Figure 10: Russia's balance of payments



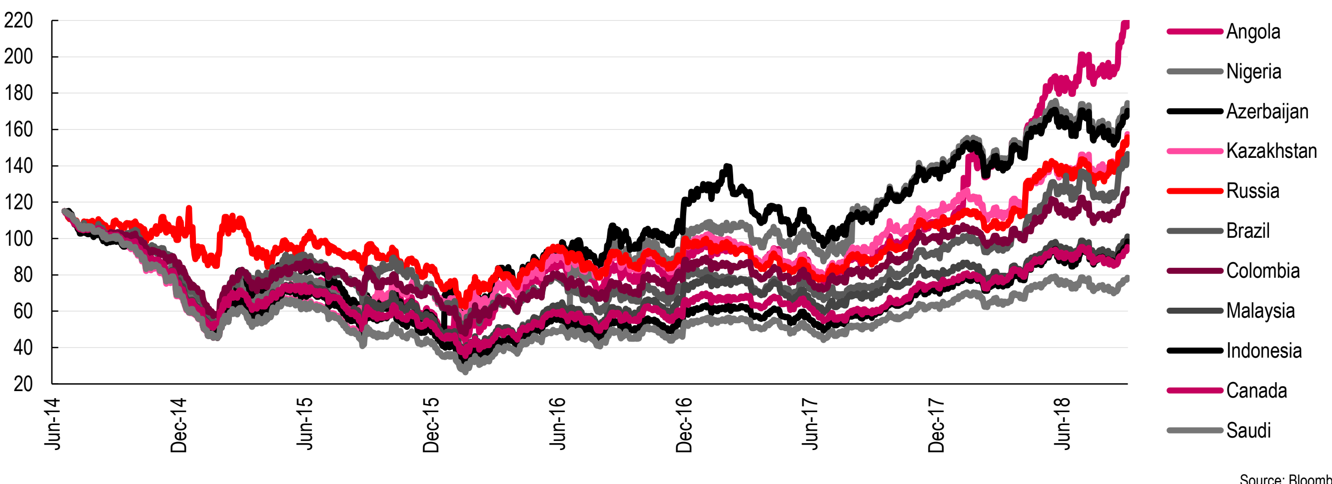
Source: Renaissance Capital

…taking the oil price in roubles to record highs. One outcome of incremental jumps in capital flight attributed to sanctions and the budget rule is the oil price in roubles is climbing higher. In 2019, we estimate it could reach c. RUB4000/bl in our $60/bl base-case scenario and close to RUB5,000/$ if the oil price stays where it is. This might be supportive for exporting companies – unless bigger cash flows are partially cut by higher taxes.

Figure 11: Oil price in roubles in 2019 at different Brent oil prices

Source: Bloomberg, Renaissance Capital estimates

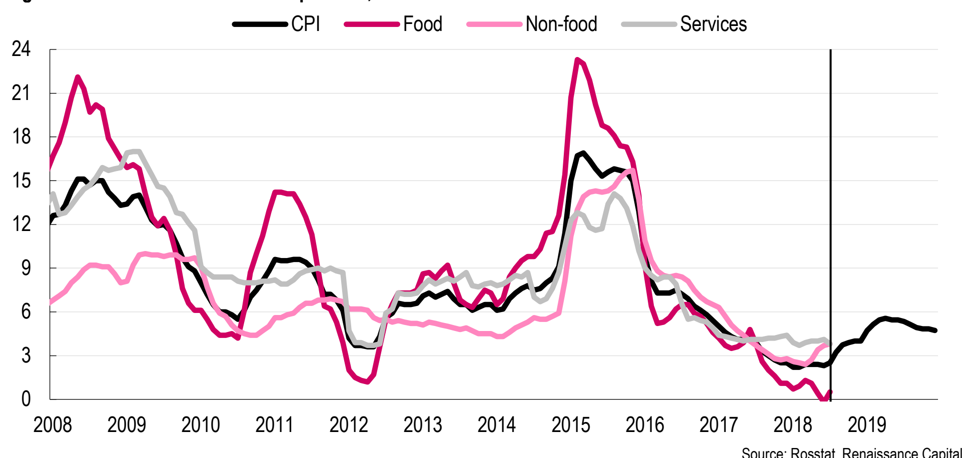
Figure 12: Oil price movements in local currency (rebased to $115/bl equivalent in June 2014)



Source: Bloomberg

But annual inflation could double in some periods due to higher VAT and a weaker currency. Inflation is likely to suffer the most. On our estimates, a direct impact on inflation from higher VAT could reach c. 1 ppt. A weaker currency would add more, as would a less strong harvest – as a result, annual inflation would more than double from recent lows and peak at 5.6% YoY in March-April 2019, according to our forecast. We also increase our 2018 year-end inflation forecast to 4.0%, from 3.7% previously, and our 2019 forecast to 4.7%, from 4.0%.

Figure 13: Russian CPI and its components, % YoY

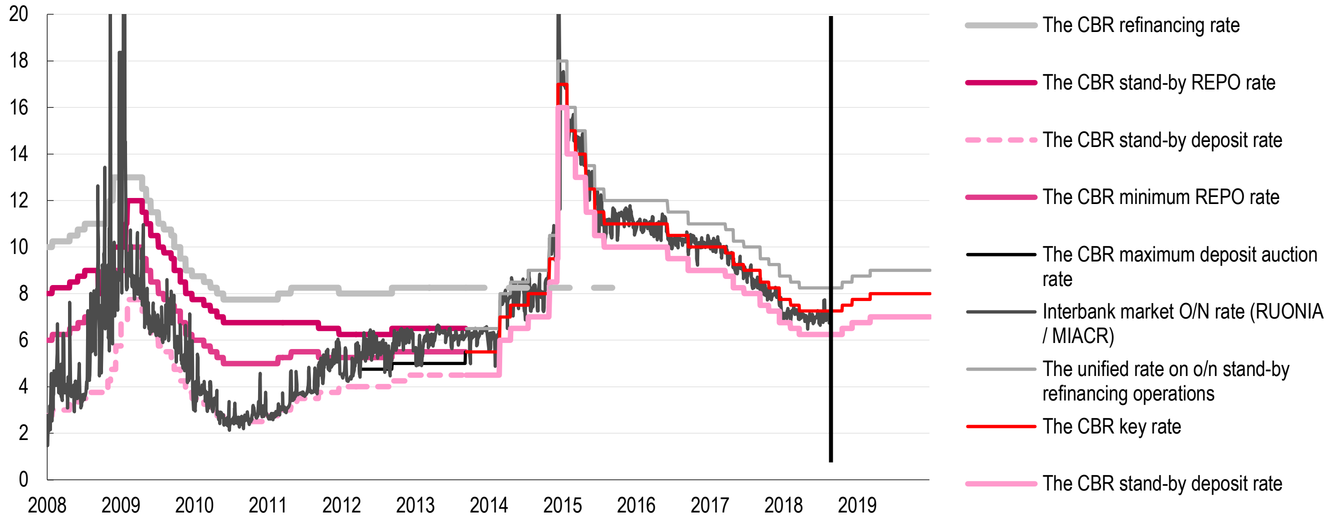


Source: Rosstat, Renaissance Capital

The big question is will the CBR hike rates? Over the past 12 months or so we have been more hawkish than the market in asserting that the terminal rate of the previous monetary policy cycle should be higher than consensus has projected. This call has actually worked very well. Now, however, we think we are going moving to a (fairly) dovish market standpoint.

- We think the CBR will not be very proactive in tightening monetary policy and will ***keep rates on hold*** but step in with a hawkish statement at the next meeting ***on 14 September***.
- ***If the oil price declines***, even if sanctions are unchanged, we think ***a rate hike will be unavoidable***. In our base-case of a $60/bl oil price, we pencil in three 25-bpt rate hikes during 4Q18 and 1Q19 to an 8% rate by April 2019. We think this could ease to 7.5% by end-2020 at a $60/bl oil price.
- If the oil price remains in the $70-80/bl range, then ***a rate hike, in our view, could be avoided***. In addition to ***a) a stable oil price***, this scenario requires ***b)*** no future sanctions, thus allowing ***the rouble to appreciate to c. RUB65/$*** at year-end; and ***c) inflation*** to perform well, hinting at ***less than 4.0% at end-2019*** and ***less than 5.5% at its peak*** in 1Q-2Q19. Is this too much? Perhaps, we do not expect it will be easy. Is this impossible? Not in our opinion.

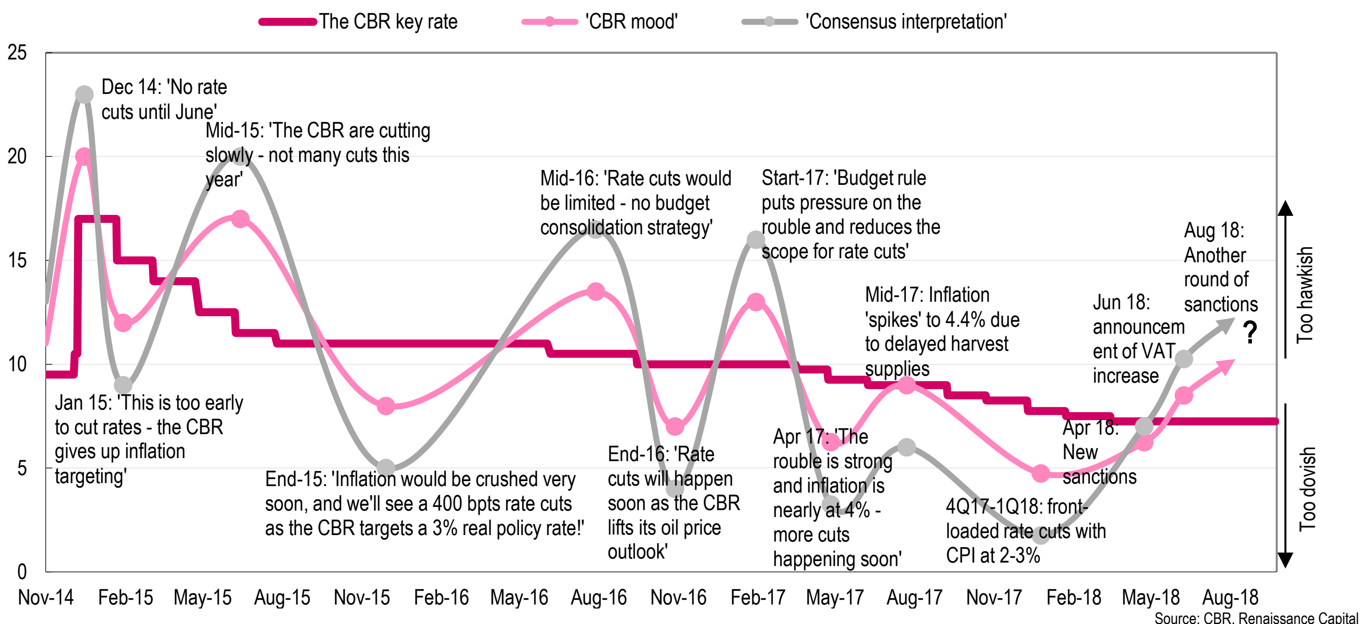
Figure 14: CBR interest rates corridor, %



Source: CBR, Renaissance Capital estimates

One more reason not to be too hawkish. Between January 2015 and February 2017, we managed to avoid the mood swings of the market, as the chart below shows. In February 2017, however, we moved to a more 'hawkish' stance in line with the market – which proved to be wrong (the start of the Finance Ministry's currency purchases at this stage did not stop the rate-cutting cycle). Thus, another argument for not being too hawkish is the chart below – it reminds us that there are always mood swings with the CBR and the market, and that this does not necessarily bring about actual rate changes.

Figure 15: Cycles in the CBR's policy stance ('CBR mood' in the chart, which we think tends to be exaggerated by market economists/analysts)



Source: CBR, Renaissance Capital

What happens if sanctions are extended to Russian state debt?

How will higher capital flight change the macro picture? First and foremost, we do not consider this likely and believe that sanctioning Russian state debt could be avoided. We apply two different approaches while quantifying the impact of potential new sanctions. In this section, we estimate how a spike in capital flight from Russia affects major macro variables. We take a reduction in foreign exposure to OFZs as an anchor, but next assume that this also triggers outflows from Russian equities and a rise in demand on foreign assets (which can capture outflows from other financial market instruments and higher domestic demand for dollars typical for volatile periods). In the next section, we estimate how a rise in the Russian risk premium affects the rouble exchange rate.

On the first approach, which we think is more accurate, we make the following assumptions:

- We take 26% as a starting point for non-residents' exposure to OFZs. The recent available print tells us this was 28% as of 1 August 2018. At the peak in 2Q18, foreigners owned 34% of the market.
- A proper estimate of non-residents' exposure to Russian equities does not appear to exist, with the possible range of estimates somewhere in between 30% and 70%. We consider capitalisation of MOEX or RTSI indices as a proxy for the volume outstanding on the Russian equity market (c. RUB10trn); we assume that at the peak, foreigners could have owned 70% of Russian equities, and could now be exposed to 50% of the market (RUB5trn).
- To capture a rise in demand for foreign assets attributed to other financial instruments and domestic demand for foreign assets, we consider the change in the level of dollarisation of household and corporate deposits (not attributed to the revaluation effect of the rouble exchange rate). We take 26% (a year-average 2018E print) as a starting point.
- We assume the CBR is likely to stop currency purchases on the market for the Finance Ministry under the budget rule – for 1.5 months, as it is doing now, in a 'soft' sanction scenario, and for three months in a 'hard' sanction scenario.

Figure 16: Dollarisation in Russia, %

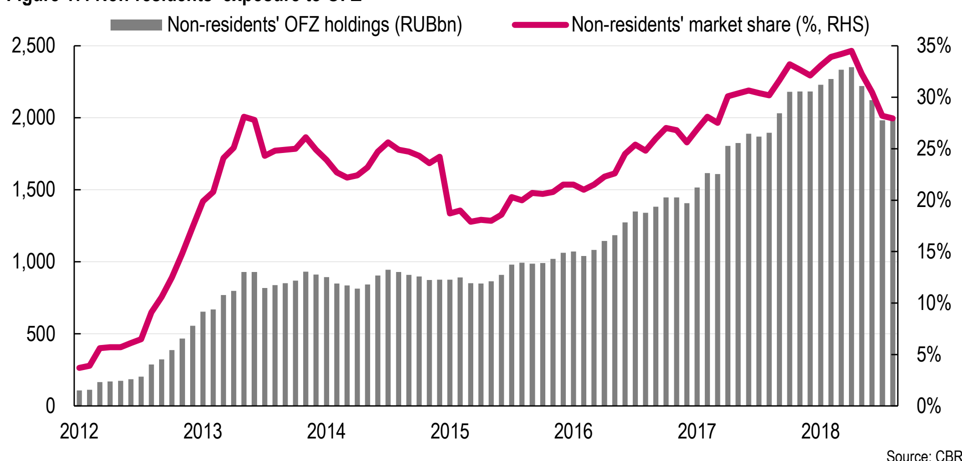
Note: We estimate the dollarisation level as a share of FX-denominated retail and corporate deposits in total retail and corporate deposits at a spot exchange rate

Source: CBR, Renaissance Capital

If debt investors reduce OFZ exposure to 2Q15 lows ('soft' sanction scenario)… If sanctions touch on Russian state debt, even newly issued debt, then we think it is rational to assume that foreign investors are also likely to reduce exposure to previously issued

securities. In our first risk scenario, we assume that they reduce exposure to 18% of the total OFZ amount outstanding – this was the minimum level seen during 2Q15, and 52% at the peak of exposure. Reduced foreign exposure to Russian state debt would take out RUB600bn from Russia, we estimate.

Figure 17: Non-residents' exposure to OFZ



Source: CBR

…then we estimate the year-average exchange rate would weaken by an extra 7-10%, depending on the oil price (Figures 18-19). Similarly, if equity investors reduce their current exposure to the market to just 52% of the peak, we estimate this would take out RUB675bn from Russia. A 3.5% rise in the level of dollarisation would trigger RUB1.9trn of outflows at a $60/bl oil price, and RUB1.6trn at an $80/bl oil price. Hence, the rise in capital outflows would reach almost RUB3trn – which we assume could be partially offset by a $10bn cut in the CBR's FX purchases. As a result, we see the year-average exchange rate weakening by an extra 10% in 2019 in our base case of a $60/bl oil price to RUB74/$ (vs RUB67/$); or by an extra 8% to RUB67/$ (vs RUB62/$) if the oil price remains roughly where it is, at $80/bl.

If OFZ investors cut exposure to just 10% of the market, then we estimate the rouble would weaken by an extra 14-18%. Likewise, a reduction in foreign exposure to just 30% of the peak would remove RUB1.2trn from Russian bonds and RUB1.5trn from Russian equities, while the rise in dollarisation by another 3.5% would deduct slightly more than RUB3trn from Russia. Cumulatively, we estimate that this would weaken the currency by 18% to RUB82/$ (vs RUB67) at a $60/bl oil price, and to RUB72/$ (vs RUB62/$) at an $80/bl oil price.

Figure 18: Scenario 1 – sanctioning Russian state debt in our $60/bl base case

	2019E at $60/bl oil	'Soft' scenario		'Hard' scenario	
	Basic case	Assumed level	Extra outflows	Assumed level	Extra outflows
OFZ, share of non-residents	26%	18%*	RUB600bn	10%**	RUB1.2trn
Equities, share of non-residents	50%	37%***	RUB675bn	20%***	RUB1.5trn
Dollarisation	26.5%	30.0%	RUB1.9trn	33.5%	RUB3.1trn
Increase in capital outflow in RUB			**RUB3.2trn**		**RUB5.8trn**
Increase in capital outflow in $			**$43bn**		**$71bn**
CBR FX purchases	$46bn	$38bn	-$8bn	$31bn	-$15bn
RUB/$, annual avg	**RUB67.1/$**	**RUB74.2/$**		**RUB81.5/$**	
RUB/$ vs basic case		**-10%**		**-18%**	

*Minimum level seen in 1Q15.
**Hypothetical bottom if only previously issued debt is sanctioned.
***Assuming same magnitude of decline from a 70% peak as in OFZs from a 34% peak.

Source: Renaissance Capital

Figure 19: Scenario 2 – sanctioning Russian state debt in an $80/bl case

	2019E at $80/bl oil	'Soft' scenario		'Hard' scenario	
	Basic case	Assumed level	Extra outflows	Basic case	Assumed level
OFZ, share of non-residents	26%	18%*	RUB600bn	10%**	RUB1.2trn
Equities, share of non-residents	50%	37%***	RUB675bn	20%***	RUB1.5trn
Dollarisation	26.0%	29.5%	RUB1.7trn	33.0%	RUB3.3trn
Increase in capital outflow in RUB			**RUB2.9trn**		**RUB6.0trn**
Increase in capital outflow in USD			**$44bn**		**$83bn**
CBR FX purchases	$83bn	$73bn	-$10bn	$62bn	-$21bn
RUB/$, annual avg	**RUB62.3/$**	**RUB67.2/$**		**RUB72.1/$**	
RUB/$ vs basic case		**-7%**		**-14%**	

*Minimum level seen in 1Q15.
**Hypothetical bottom if only previously issued debt is sanctioned.
***Assuming same magnitude of decline from a 70% peak as in OFZs from a 34% peak.

Source: Renaissance Capital

The impact on the Russian macro implies lower growth and bigger rate hikes but neither of these effects are dramatic, in our view... If sanctions get tighter, then higher inflation, tighter credit conditions, as well as greater uncertainty are likely to put an extra drag on Russian growth (Figure 20).

…with slightly positive or marginally negative (c. -1%) growth… In our 'soft' sanction scenario described above we expect Russia to secure positive GDP growth both at a $60/bl and $80/bl oil price, which would turn into marginally negative territory of c. 1% under our 'hard' sanction scenario, ie, growth decline will be much lower than in 2009 (-8%) or in 2015 (-2.7%).

…single-digit inflation... We also assume different variants for the CBR policy rate, but do not expect this to be higher than 15% at end-2019.

…and perfect sustainability indicators. We expect a weaker currency and weaker growth will reduce Russian imports – taking the current account and reserves adequacy ratios to new highs. A weaker rouble at a high oil price should also boost the budget deficit. Thus, although potential new sanctions will make the Russian development story more muted and constrain current and longer-term growth, in our view, this should not undermine general economic stability, with the macro shock being even milder than in 2009 and 2014/2015.

Figure 20: Potential impact of state debt sanctions on Russian macro

Year	2018E	2019E					
Brent oil, $/bl	70	60			80		
		Base case	'Soft' Sanctions	'Hard' sanctions	Base case	'Soft' Sanctions	'Hard' sanctions
Real GDP growth	1.9%	1.4%	0.5%	-1.1%	1.8%	0.7%	-0.6%
RUB/$, annual avg	62.2	67.1	74.2	81.5	62.3	67.2	72.1
Inflation, annual avg	3.0%	5.2%	6.4%	8.6%	4.8%	5.4%	6.3%
Policy rate by year-end	7.5%/7.25%*	8.0%	9.5%	15%	7.25%	8.0%	12%
Current account, $bn	96	68	101	127	104	137	167
% of GDP	5.9%	4.3%	6.9%	9.5%	5.9%	6.4%	10.9%
External debt, $bn	469	458	447	437	469	459	451
% of GDP	29%	29%	31%	33%	27%	28%	29%
FX reserves, $bn	484	546	538	531	583	573	562
Months of imports cover	23	26	29	31	25	27	29
Budget balance, % of GDP	1.8%	1.6%	2.1%	2.8%	3.3%	3.7%	4.4%
GDP, RUBtrn	101.6	106.0	107.1	108.3	109.8	110.2	110.7
GDP, $bn	1,634	1,579	1,447	1,328	1,765	1,640	1,536

*We think the rate will be 7.5% in 2018 if oil prices decline to hit $60/bl next year but 7.25% (unchanged) if oil prices remain closer to $80/bl and no new sanctions arrive.

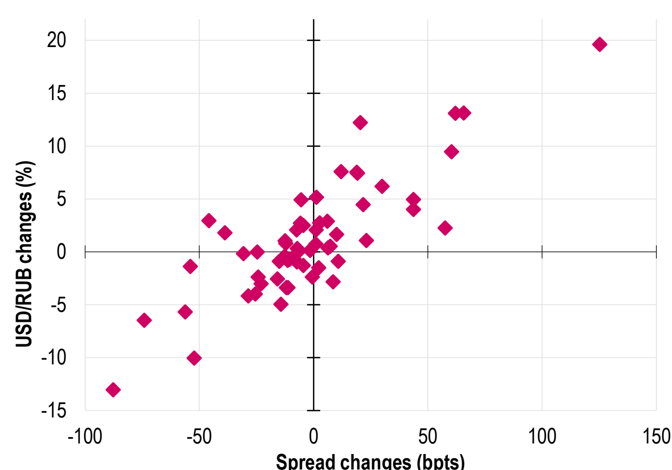
Source: Renaissance Capital estimates

Important note –figures above year-average numbers. This implies that although we forecast, for example, the rouble to average RUB82/$ in 2019 if oil declines to $60/bl and the impact of sanctions are significant – in the short term, the rouble could spike to triple-digit territory. We acknowledge this limitation of our analysis. A fairly good side note for the rouble (not for holders of Russian assets) is that the change in capital flows is calculated on the base of the year-average exchange rate and assuming that the prices of Russian bonds and equities remain at the same level as they are today. In practice, in the event of a huge sanction shock, the prices of these assets will fall quickly, and significantly – but this might also limit actual outflows, which will be driving the currency weaker.

And what if the Russian risk premium rises due to sanctions?

A separate contagion channel could come from a rising risk premium. Our analysis below is based on the econometric estimate of a historical link between Russian risk premium and the rouble. We acknowledge that this might be less sophisticated – it is more like a 'black box' stating how an increase in the Russian risk premium in the past affected the rouble exchange rate, and thus should be applied with some degree of caution. We think it could provide some useful colour for investors, too. It appears rational to us that a higher risk premium weakens the value of the currency (Figures 21-22).

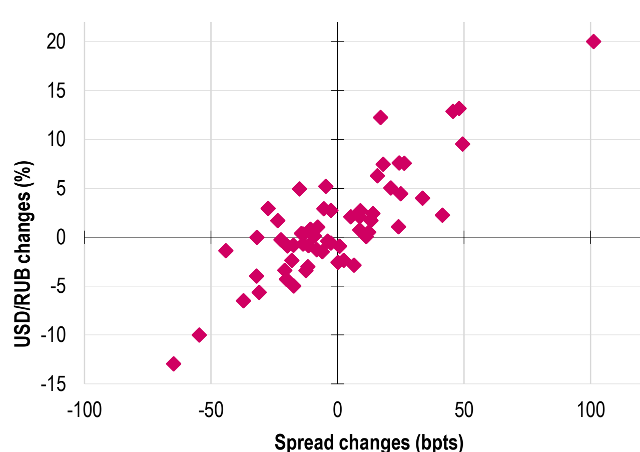
Figure 21: Russia 2023 vs UST / USDRUB



Note: Monthly data

Source: Renaissance Capital

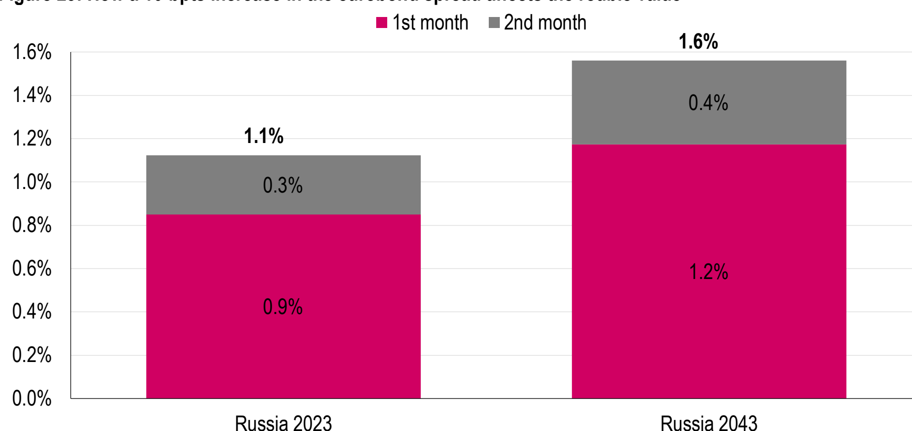
Figure 22: Russia 2043 vs UST / USDRUB



Source: Renaissance Capital

A 10-bpts rise in the Russian risk premium leaves the rouble weaker by c. 1-1.5%, on our estimates. Assessing a few different models (regression models in first differences), we find that a 10-bpts increase in the Russia 2023 Eurobond spread vs UST would make the rouble weaker by 1.1%, while the same rise in the Russia 2043 spread vs UST would weaken the rouble by 1.6%. We do not consider Russia 2030 data (issued in 2010) as this was affected by Otkritie non-market transactions (April 2015 – December 2017) and includes periods of both a tightly managed and flexible exchange rate regime. We find that the biggest impact would be achieved in two months' time.

Figure 23: How a 10-bpts increase in the eurobond spread affects the rouble value



Source: Renaissance Capital

The rouble will stabilise at RUB71/$ if risk premium widens by 40 bpts to 200 bpts. Alternative estimates between the risk premium and the currency are presented in Figure 24. We take the Russia 2023 bond as a proxy for the Russian risk premium in this exercise.

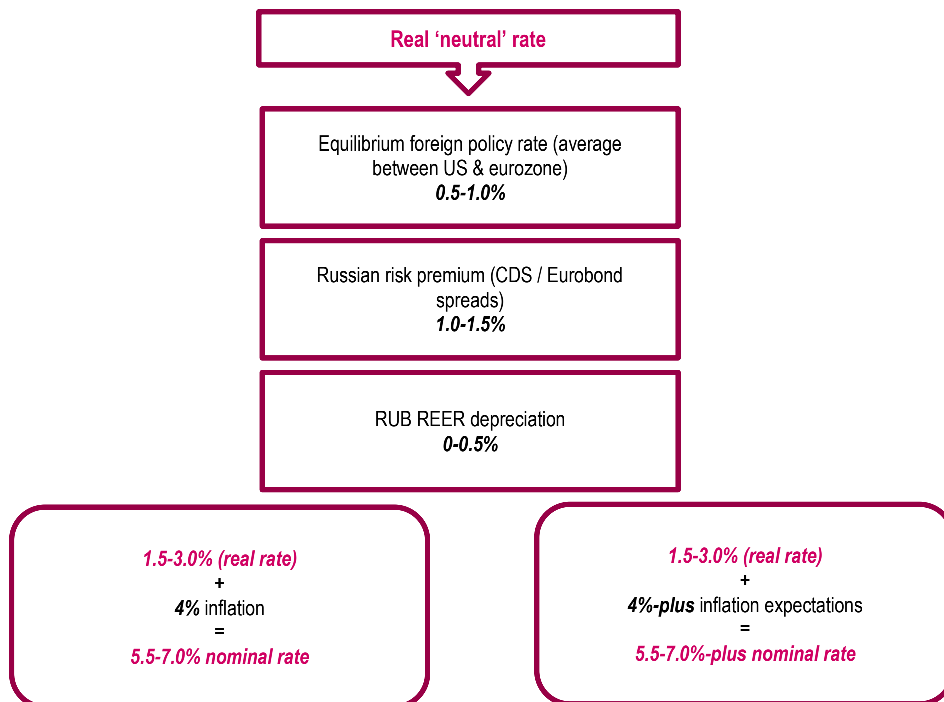
Figure 24: Rouble/$ estimates depending on Russian risk premium (Russia 2023 – UST spread):

Spread, bpts	RUB/1$
Average in August 2018	
153	66.5
Future assumptions	
100	63.5
120	65.0
140	66.4
160 (current)	**67.9**
180	69.5
200	71.1
250	75.2
300	79.5
350	84.1

Source: Renaissance Capital

The most direct medium-term impact of a higher risk premium is the change in neutral rate. Thus, if markets (hopefully) gain a better understanding of what the new Russian risk premium might be when the geopolitical situation stabilises, this could provide an indication as to where the Russian neutral rate could be (Figure 25).

Figure 25: Approaches to calculate neutral policy rate



Source: Renaissance Capital

Figure 26: Russia – key economic indicators

Ratings (M/S&P/F): Ba1/BB+/BBB- **EODB rank: 35 (40) – Strong** **Corruption rank: 131 (119) – Weak** **RenCap legal score: 50 (56) – Middle**

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018E	2019E	2020E
Activity															
Real GDP (% YoY)	8.2	8.5	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-2.8	-0.2	1.5	1.9	1.4	2.4
Private consumption (% YoY)	12.2	14.3	10.6	-5.1	5.1	6.8	7.9	5.2	2.0	-9.4	-2.8	3.4	3.8	2.6	4.0
Government consumption (% YoY)	2.3	2.7	3.4	-0.6	-1.5	1.4	2.6	0.9	-2.1	-3.1	0.9	0.4	0.2	0.4	0.4
Investment (% YoY)	16.7	21.0	10.6	-14.4	5.9	9.1	5.0	1.3	-1.8	-11.2	0.8	4.3	3.3	2.7	4.5
Industrial production (% YoY)	6.3	6.8	0.8	-9.2	8.3	4.8	2.5	0.3	1.7	-3.4	1.3	2.1	3.0	1.6	2.3
Unemployment rate (% YoY)	7.2	6.1	6.3	8.4	7.5	6.6	5.5	5.6	5.3	5.9	5.3	5.1	4.9	4.8	4.8
Nominal GDP (RUBbn)	26,917	33,248	41,277	38,807	46,309	55,967	66,927	71,055	79,200	83,233	86,149	92,037	101,620	105,962	111,317
Nominal GDP ($bn)	990	1,299	1,658	1,224	1,523	1,904	2,159	2,227	2,052	1,356	1,287	1,579	1,634	1,579	1,625
Population (mn)	142.8	142.8	142.7	142.9	142.9	143.0	143.3	143.3	143.7	146.8	147.1	147,4	147,7	147,9	148,1
GDP per capita ($)	6,930	9,095	11,617	8,567	10,660	13,312	15,066	15,544	14,278	9,234	8,748	10,710	11,061	10,677	10,973
Gross domestic saving (% of GDP)	29.0	29.3	28.8	19.4	24.4	27.9	28.0	25.1	25.0	27.2	27.3	27,0	27,7	27,6	28,0
Stock of bank credit to corp/ households (RUBbn)	8,183	12,506	16,527	16,116	18,148	23,266	27,709	32,456	40,866	43,985	40,939	42,366	47,275	52,822	59,161
Stock of bank credit to corp/ households (% of GDP)	30.4	37.6	40.0	41.5	39.2	41.6	41.4	45.7	51.6	52.7	47.5	46.0	46.5	49.9	53.1
Deposits (RUBbn)	8,340	11,890	14,749	17,131	21,081	26,082	30,120	34,931	43,814	51,907	50,003	53,703	60,147	67,365	74,102
Loan-to-deposit ratio	98.1	105.2	112.1	94.1	86.1	89.2	92.0	92.9	93.3	84.7	81.9	78.9	78.6	78.4	79.8
Prices															
CPI (average % YoY)	9.7	9.0	14.1	11.7	6.9	8.4	5.1	6.8	7.8	15.6	7.1	3.7	3.0	5.2	3.7
CPI (end-year % YoY)	9.0	11.9	13.3	8.8	8.8	6.1	6.6	6.5	11.4	12.9	5.4	2.5	4.0	4.7	3.8
Nominal wages (monthly), RUB	10,634	13,593	17,290	18,639	20,950	23,532	26,803	29,729	32,611	34,274	36,845	39,144	42,941	46,376	50,086
Wage rates (% YoY, nominal)	24.3	27.8	27.2	7.8	12.4	12.2	13.9	12,8	9.5	5.1	7.5	7.3	9.7	8.0	8.0
Fiscal balance															
Consolidated government balance (% of GDP)	7.4	5.4	4.1	-5.9	-3.5	1.6	0.0	-0.8	-0.5	-2.6	-3.4	-1.4	1.8	1.6	1.0
Total public debt (% of GDP)	8.9	7.1	5.2	9.4	9.6	9.9	10.0	11.4	14.4	14.6	16.1	15.7	16.7	17.6	18.7
External balance															
Exports ($bn)	304	354	472	303	401	522	528	523	494	342	282	354	422	382	386
Imports ($bn)	164	223	292	192	249	324	336	341	308	193	192	238	254	248	256
Trade balance ($bn)	140	131	180	111	152	198	192	182	186	149	90	116	168	134	130
Trade balance (% of GDP)	14.1	10.1	10.9	9.1	10.0	10.4	8.9	8.2	9.0	11.0	7.0	7.3	10.3	8.5	8.0
Current account balance ($bn)	94.7	77.8	103.5	48.6	70.3	98.8	71.4	34.1	58.4	69.0	25.5	35.4	96.2	68.2	64.0
Current account balance (% of GDP)	9.6	6.0	6.2	4.0	4.6	5.2	3.3	1.5	2.8	5.1	2.0	2.2	5.9	4.3	3.9
Gross FDI ($bn)	37.6	55.9	74.8	36.6	43.1	55.1	50.6	79.3	18.5	5.9	30.9	27.2	15.0	15.0	15.0
Gross FDI (% of GDP)	3.8	4.3	4.5	3.0	2.8	2.9	2.3	3.6	0.9	0.4	2.4	1.7	0.9	0.9	0.9
Current account balance plus FDI (% of GDP)	13.4	10.3	10.8	7.0	7.4	8.1	5.7	5.1	3.7	5.5	4.4	4.0	6.8	5.3	4.9
Exports (% YoY, value)	24.6	16.4	33.3	-35.8	32.3	30.2	1.1	-0.9	-5.7	-30.8	-17.4	25.4	19.3	-9.5	1.0
Imports (% YoY, value)	31.2	36.0	30.9	-34.2	29.7	30.1	3.6	1.7	-9.8	-37.3	-0.5	23.9	6.8	-2.4	3.2
Foreign exchange reserves ($bn)	304	479	427	439	479	499	538	430	385	368	378	433	484	546	588
Import cover (months of merchandise imports)	22.2	25.8	17.5	27.4	23.1	18.5	19.2	15.1	15.0	22.9	23.6	21.8	22.9	26.4	27.6
Debt indicators															
Gross external debt year-end ($bn)	313	464	480	466	489	539	636	716	600	518	512	518	469	458	446
Gross external debt (% of GDP)	32	36	29	38	32	28	29	32	29	38	40	33	29	29	27
Gross external debt (% of exports)	103	131	102	154	122	103	121	137	122	152	181	146	111	120	116
Total debt service ($bn)	109,1	171	167	154,4	158	177	205	230	179	128	134	137	140	135	131
Total debt service (% of GDP)	11	13	10	13	10	9	9	10	9	9	10	9	9	9	8
Total debt service (% of exports)	36	48	35	51	39	34	39	44	36	37	47	39	33	35	34
Interest & exchange rates															
Broad money supply (% YoY)	48.7	43.5	0.8	17.7	31.1	22.3	11.9	14.6	2.2	11.4	9.2	9.5	10.5	8.5	11.0
Refinancing rate year-end (%)	11.0	10.0	13.0	8.75	7.75	8.00	8.25	8.25	8.25	8.25	10.0	7.75	7.5	8.0	7.5
REPO rate year-end (%)	6.5	6.5	9.5	6.0	5.0	5.25	5.50	5.50	17.0	11.0	10.0	7.75	7.5	8.0	7.5
Deposit rate year-end (%)	2.3	2.8	7.25	4.0	3.0	4.00	4.25	4.50	16.0	10.0	9.0	6.75	6.5	7.0	6.5
3-month interest rate (MosPrime avg %)	5.1	5.9	9.8	13.7	4.3	5.1	7.1	7.00	10.5	13.8	11.2	9.3	7.6	7.8	7.5
3-month rates minus $-LIBOR	-0.1	0.6	6.8	13.0	4.0	4.8	6.7	6.8	10.3	13.5	10.4	8.0	5.4	4.8	4.3
Exchange rate (RUB/$) year-end	26.3	24.5	29.4	30.2	30.5	32.1	30.5	32.7	56.2	72.9	61.5	57.6	65.5	68.0	70.0
Exchange rate (RUB/$) annual average	27.2	25.6	24.9	31.7	30.4	29.4	31.0	31.9	38.6	61.4	67.0	58.3	62.2	67.1	68.5
Exchange rate (RUB/EUR) year-end	34.7	35.9	42.7	43.3	40.8	41.7	40.3	44.9	68.4	79.6	64.7	68.9	77.3	85.0	91.0
Exchange rate (RUB/EUR) annual average	34.1	35.0	36.5	44.1	40.3	40.9	39.9	42.4	50.9	68.1	74.1	65.9	73.4	81.9	89.1

Source: Rosstat, CBR, Finance Ministry, Federal Treasury, Bloomberg, IMF, World Bank, Renaissance Capital estimates

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