Russia Economic Review

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The CBR cut rates, S&P upgraded its Russian ratings outlook and the MoF conducted a successful Eurobond issue. IP growth returned to positive territory but wage and retail sales were disappointing.

- Russia's central bank (CBR) cut its key interest rate by 50bps down to 10% and announced that there would be no further monetary easing until next year.
- S&P upgraded Russia's outlook to stable citing decreased external risks and the relatively strong external position. Russia's government issued $1.25bn of Eurobonds to help to cover the widening fiscal deficit.
- While industrial output returned to positive growth of 0.7%Y/Y in August, retail sales fell by 5.1%Y/Y.
- The labour market is continuing to tighten as the drop in the unemployment rate in August to 5.2% has shown. But wage growth remained negative at -1.0%Y/Y following a significant downside revision in July.

The Central Bank of Russia cut rates by 50bps

At its regular board meeting on monetary policy on 16 September the CBR decided to cut its key interest rate (one-week repo rate) by 50bps to 10%. And while the decision was in line with the Bloomberg consensus forecast, the Bank subsequently made an unusually straight forward announcement that it is going to keep this rate at least until next year, which means that there will be no monetary easing at the scheduled regular board meetings in October and December.

The decision to lower the key interest rate was made due to the continuing disinflationary trend while the CBR also alluded to the unstable pace of economic recovery. The CBR forecasts inflation to fall to 4.5%Y/Y by around September next year and to reach the inflation target of 4%Y/Y at the end of 2017. The CBR also predicts a return to positive economic growth in the second half of 2016. However, growth is expected to remain low – less than 1% - next year under the assumption that oil prices will be sustained at the level of $40pbl for the relevant period.

S&P upgraded its Russian outlook to stable

In mid-September, S&P announced an upgrade of the outlook on its Russian rating (BB+) from negative to stable. The decision was based on the view that external risks have decreased significantly, which reflects the fact that the Russian economy is proceeding relatively smoothly through the adjustment process related to lower oil prices and has been able to maintain a relatively strong external position. Moderate government debt was also a positive, providing cause of optimism for continuing economic recovery and a better investment outlook.

Ministry of Finance issued $1.25bn of Eurobonds

On 22 September, the Russian Finance Ministry issued $1.25bn of Eurobonds in an attempt to raise the additional funds needed to cover its widening fiscal deficit. The lower-than-expected oil price and relatively slow pace of economic recovery suggest that the government will exceed its budget deficit target of 3% of GDP, perhaps by around 0.3ppt, requiring additional sources of funding. While the issuance of Eurobonds was a normal practice for Russia in recent years, until earlier this year it had not borrowed from the international bond market since 2013 given the unfavourable geopolitical situation, not least sanctions. But following that pause, the Russian government decided to re-start its Eurobond issuance in May this year when it offered investors $1.75bn of sovereign bonds – out of the $3bn limit determined by this year Budget Law. But while the issue was successful and even oversubscribed, the cold shoulder from western investment banks which refused to participate and two long months of uncertainty during negotiations with Euroclear, which began to re-accept Russian bonds only in July, had suggested that this source of funding might be relatively unstable and complicated.

Nevertheless, the positive decision made by Euroclear to accept Russian bonds and the "window" before the possible Fed rate hike later this year encouraged the government to act this time. As in May, Russia's state-owned VTB Capital was the sole organizer and the issue was heavily oversubscribed to leave the yield at 3.82%, almost 1% lower compared to the previous offering. And while there appears no room for additional issue this year, this successful return to the international stage suggests that Russia may gradually increase its self-imposed limits for Eurobonds issuance to bring the scale of borrowing close to $6-7bn a year as it was before the Ukrainian crisis of 2014.

Industrial production in August returned to positive territory, but retail sales surprised on downside

In August, industrial production returned to positive territory and increased by 0.7%Y/Y compared to the negative growth of 0.3%Y/Y in the previous month and the Bloomberg consensus forecast of 0.6%Y/Y. Over the first eight months of the year IP increased by 0.4%Y/Y compared to the figure of -3.2%Y/Y for the same period one year earlier. The Russian mining sector has shown stable growth this year around 2%Y/Y and this trend continued in August with growth of 1.8%Y/Y (0.8%M/M). For the first eight months mining output rose by 2.4%Y/Y compared to growth of only 0.1%Y/Y over the same period a year ago. Manufacturing sector growth in the second quarter was positive, albeit less than 1%, and slipped to -1.5%Y/Y in July before moving back slightly into positive territory at 0.1%Y/Y in August. Over the first eight months of the year, manufacturing output decreased by 0.8%Y/Y (a year earlier it fell by 5.2%Y/Y over the same period) suggesting that Russian manufacturing is indeed stabilising but the recovery process is slow and the road is bumpy. Electricity, gas and water output rose 1.3%Y/Y (1.8%M/M) in August and 0.6%Y/Y in the first eight months of the year (down 0.3%Y/Y during the same period of 2015).

While they rose 3.2%M/M, retail sales fell 5.1%Y/Y in August, a downside surprise, albeit a touch better than the revised reading of the previous month of -5.2%Y/Y (4.3%M/M). And the rate of decline has almost halved compared to a year ago, when retail sales dropped by 9.4%Y/Y in August and by 8.2%Y/Y in the first eight months of the year.

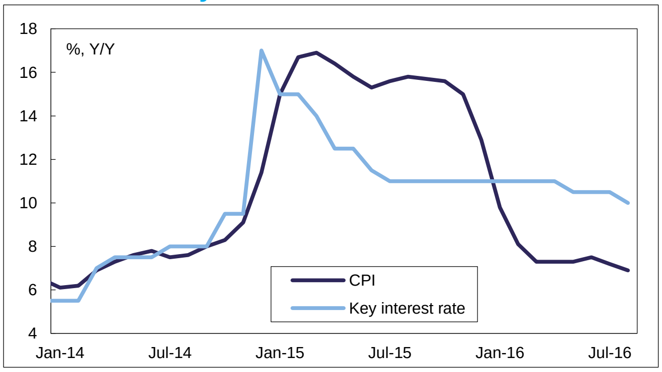
Unemployment continues to fall, but the latest wage data were disappointing

Unemployment decreased further to 5.2% in August and declined by 0.1ppt compared to a month ago suggesting that the government's aim to keep the unemployment rate below 6% this year is achievable. And while the labour market is continuing to tighten, this is still not enough to push real wages up. In August, real wages dropped by 1.0%Y/Y and July's reading was revised to the downside from the preliminary estimate of growth of 0.6%Y/Y to a decline of 1.3%Y/Y.

The ruling United Russia party won a constitutional majority in lower house of parliament

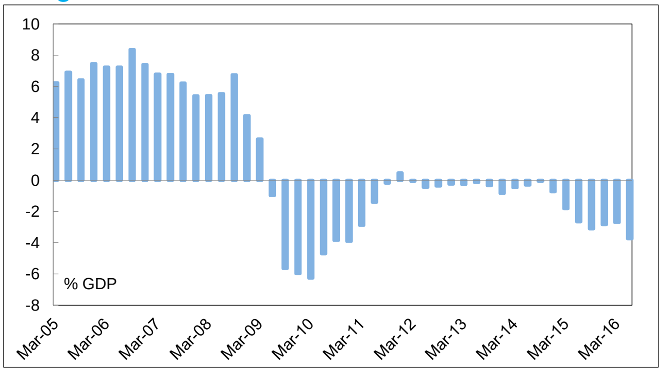
While the turnout was less than 50% and revealed a mixed picture of declining interest in politics alongside satisfaction with the status quo – underpinned by an 80% approval rate for President Putin – the ruling party, United Russia, for which Prime Minister Dmitry Medvedev is a leader, won the elections securing a solid 54% of votes. This allowed the party to obtain 343 seats (compared to 238 seats previously in 2011) out of a total of 450 in the lower house of state Duma and therefore gain a constitutional majority for which two thirds of all seats are required. The Communist party and the Liberal Democrats came second and third respectively, each with 13% of the vote, while Just Russia received 6% and no other political party could overcome the hurdle of 5% of votes needed to be passed to qualify for representation in parliament.

Inflation and key interest rate



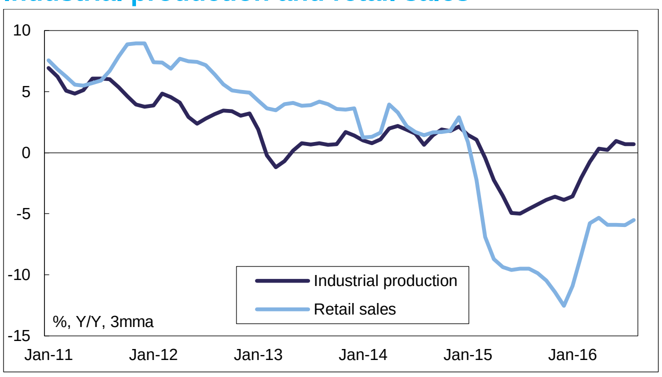
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Budget balance



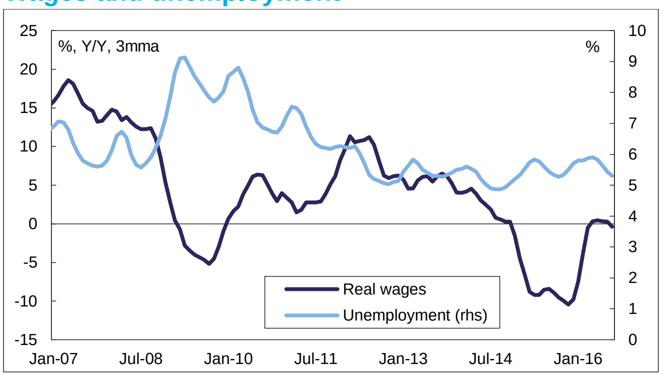
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Industrial production and retail sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Wages and unemployment



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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Credit Rating Agencies

[Standard & Poor's]

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[Moody's]

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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